VOLUME 6 • NUMBER 2
COMPLETE TABLE OF CONTENTS • PAGE 65
INDEX OF CURRENT CASES • PAGE 129

THE JOURNAL OF Taxation

Bus Admin

A NATIONAL JOURNAL OF CURRENT NEWS & COMMENT FOR PROFESSIONAL TAX MEN

Supreme Court kills ordinary-loss deduction on guaranteed loans; uncertainty remains

by Burton W. Kanter

How to handle vacation-pay accruals pending Treasury's action on rules

by William J. Schwanbeck

Final Regulations clarify rules on distributions under pension and profit-sharing plans

by John A. Cardon

How to incorporate the going business and save taxes 72

Tax tips on handling PHCs and collapsible corporations 74

Getting best tax treatment for payments for partner's share 79

Tax traps in covenants not to compete face buyer and seller .. 86

Tax Court follows narrow definition of capital asset 88

How new rules apply to taxation of annuities 95

Agran case; California CPAs explain why no appeal 104

New data on income of accounting and law partnerships 105

An evaluation of new costs and benefits under OASI 106

State tax men in quandary over Michigan's Panhandle case 110

Rep. Mills outlines plans for technical revision of Code 112

Tax traps in buy-sell agreements .. 116

An executor's check list: returns, liabilities 120

Virgin Islands "loophole" not so attractive 126

February 1957

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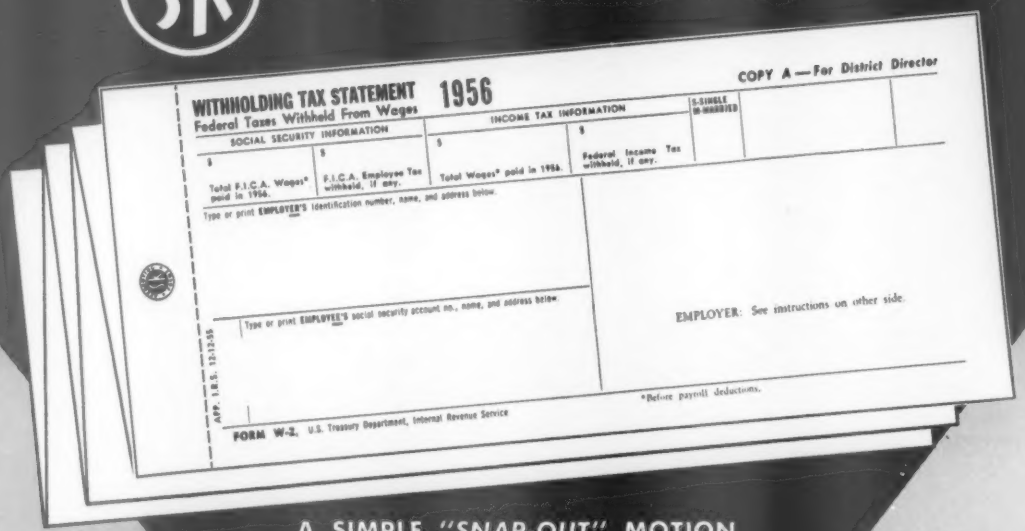

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February contents

REGULAR DEPARTMENTS

Accounting • 84

84 How to handle vacation-pay accruals pending Treasury's action on rules, *by William J. Schwanbeck*

86 Both buyer and seller face tax traps in covenants not to compete, *by T. Grayson Maddrea*

88 Tax Court follows narrow definition of capital asset in auto dealer case

88 New accounting decisions

Compensation • 100

100 Final Regs. clarify rules on distributions under pension and profit-sharing plans, *by John A. Cardon*

103 New compensation decisions

Corporations • 66

66 Supreme Court kills ordinary-loss deduction on guaranteed loans; uncertainty remains, *by Burton W. Kanter*

71 Holzman warns not to ignore accumulated earnings threat

72 Incorporating the going business; how to find the method with the least tax cost, *by Gerald J. Kahn*

74 Tax tips on handling the personal holding company and collapsible corporation, *by Charles D. Leist*

77 New corporate decisions this month

Estate and gift taxation • 120

120 Tax procedures for the executor; a check list of returns, election, liabilities, *by Byron E. Bronston*

123 New estate and gift decisions

Foreign • 126

126 Virgin Islands loophole probably not so attractive as press reports suggest

127 New foreign decisions

Partnerships • 79

79 How to obtain best tax treatment for payments for a partner's interest *by Arthur B. Willis*

82 Partnership income shows slowest rate of increase

82 New partnership decisions this month

Payroll • 106

106 An evaluation of costs and benefits under OASI as recently amended, *by Benjamin B. Kendrick*

109 Employer's statement on sick pay that employee can use

Personal • 95

95 How new rules apply to taxation of annuities in typical policy situations, *by Richard Alden*

96 How fancy can you be, or what is "necessary expense?"

95 Taxes make people do crazy things

96 New decisions affecting individuals

Planning • 116

116 Tax aspects of retiring an interest in a small company with buy-sell agreement, *by John S. Pennell*

Policy • 112

112 Representative Mills outlines plans for technical revision of Code; opposes tax cuts now

Professional tax practice • 104

104 Agran case: California CPAs explain why no appeal to Supreme Court

105 New data on income of accounting, law partnerships revealed by IRS survey

105 Professional tax advice on a "hospitalization basis?"

State and local • 110

110 State tax men in quandary over denial of certiorari in Michigan's Panhandle case

111 Mass. case holds deliveries out of state are interstate; not includable in formula

Authors in this issue

95 Richard Alden
120 Byron E. Bronston
100 John A. Cardon
74 Gerald J. Kahn
66 Burton W. Kanter
106 Benjamin B. Kendrick
72 Charles D. Leist
86 T. Grayson Maddrea
116 John S. Pennell
84 William S. Schwanbeck
79 Arthur B. Willis

New exempt institutions decisions • 125

New fraud and negligence decisions • 98

Miscellaneous decisions • 83

New procedural decisions • 127

New trust and estate decisions • 124

Index of new decisions in this issue • 129

TAX CONSEQUENCES OF

Corporate organization and distributions

EDITED BY RICHARD L. GREENE, LL.B.

Supreme Court kills ordinary-loss deduction on guaranteed loans; uncertainty remains

by BURTON W. KANTER

In the Putnam decision, handed down several weeks ago, the U. S. Supreme Court ruled that loss from payment of a guaranteed loan, defaulted on by a corporation in which taxpayer was interested, was not deductible by him as an ordinary loss. Despite the fairly clear conclusion reached by the Court, this author finds confusion and inconsistency still possible. This device, much used by tax planners recently, must now be evaluated by the tax man to determine whether the door is really shut and whether other arrangements can accomplish the same end. In this article views of the Tax Court, the circuit courts, the Supreme Court and legislation are examined to help the practitioner determine his proper course of action.

SINCE THE bad-debt provisions of the 1954 Code reflect relatively small change in basic, underlying concepts from the 1939 Code, the Supreme Court decision in *Putnam v. Commissoner*, which arose under the 1939 Code, will have a very considerable effect upon our ways of thinking about the deduction for bad debts and related losses under present law. It was held in *Putnam* that the loss sustained by a guarantor upon satisfaction of his guaranty obligation is deductible only as a nonbusiness bad debt and not as an ordinary loss from a transaction entered into for profit. But this decision leaves some unanswered questions.

Unfortunately, despite the rendering of a well-reasoned opinion by the Supreme Court and the expression by it of a very significant philosophy regarding bad-debt and related losses sustained upon "investment loans," the post-*Putnam* era promises to be not much less fraught with oddities and inconsistencies in treatment of like economic losses than the pre-*Putnam* period. The former Tax Court view put a premium on timing the payment of a guaranty so that the corporate debtor was not only extinct, but was also insolvent as well at the time of satisfying the guaranty obligation. And it is not wholly clear that such result cannot under any circumstances still occur. A consequence of the majority Courts of Appeals view (and the Tax Court view when the debtor was no longer legally existent) was that in the absence of subrogation the payment upon a guaranty gave rise to a loss rather than a bad debt. Thus in cases where the payment could not have been said to have been made in a transaction entered into for profit no deduction at all was allowed. This result did not knit well with the otherwise allowable nonbusiness bad-debt deduction in comparable situations, such as in the case of an accommodation endorser. And it is not inconceivable that such a result may still occur in the case of an indemnity loss.

Code structure

Business bad debts may be deducted by corporations and individuals under Section 166. Taxpayers other than corporations may deduct nonbusiness bad debts only in accordance with 166(d)(1)(B), which treats the loss from such debts as a short-term capital loss (offset against capital gains plus $1,000 of other income annually over a six-year period.)

A nonbusiness bad debt is defined in Section 166(d)(2) as any debt other than one (a) created or acquired in connection with a taxpayer's trade or business or (b) the loss from the worthlessness of which is incurred in the taxpayer's trade or business. But Section 166(f), which is new to the 1954 Code, provides in effect that a payment by a noncorporate taxpayer in discharge of either part or all of an obligation as guarantor, endorser or indemnitor of a noncorporate-taxpayer obligation is to be treated as a business bad debt. The borrowed funds, however, must have been used in the trade or business of the borrower. And the obligation of the borrower must have been worthless (without regard to the guaranty, endorsement, or indemnity) at the time of the payment.

Debt vs. equity financing

Tax considerations cause those interested in small business to prefer to finance an enterprise by either lending to it directly or by guaranteeing loans by others, rather than by making a direct equity "risk" investment. If the enterprise is successful, the loan is returned to the creditor free of individual income tax. At the same time the corporation is permitted a deduction for interest payments. If the corporate venture is unsuccessful, the creditor may in some circumstances be entitled to a full deduction for loss from a business bad debt rather than being limited to a capital loss upon the worthlessness of his stock investment. In the usual case, however, the debt loss would be from a nonbusiness bad debt and deductible only as a short-term capital loss.

If a taxpayer cannot or does not prefer to advance monies directly, debt-financing may be undertaken by assuming secondary liability for third-party advances through a guaranty or endorsement of a note or a contract of surety or indemnity. The corporation is still entitled to an interest deduction on

[1] Spring City Foundry Co. v. Comm'r, 202 U.S. 132 (1934).

[2] Only infrequently is claim made for treatment as a business bad debt or business loss, since in either case, when claim therefore is made by the stockholder and officer creditors, the issue ultimately resolves itself into defining the nature of taxpayer's trade or business and the relation of the debt or loss to that trade or business, matters which are considerably more difficult to prove than merely that the loss was incurred in a transaction entered into for profit; and if a trade or business exists and the transaction involved relates to such trade or business then clas-

the loan. And, particularly if the funds have been borrowed from an independent lending institution, the interested taxpayer-creditor, now once removed, has probably eliminated the possibility that the loan will be deemed a capital contribution under the thin-incorporation doctrine, even upon satisfaction of the guaranty obligation. But until the *Putnam* decision, the most significant tax aspect of financing by guaranteeing loans from third parties has been the possibility of obtaining an ordinary-loss deduction in case the enterprise fails without facing the very difficult task of showing a proximate relation of the guaranty to some separate business carried on by the taxpayer.

Leading up to Putnam

The basic tax principle applied in determining the deductibility of a loss upon a loan (or a guaranty of a loan) is that bad debts and other losses are mutually exclusive.[1] This is the *Spring City* rule. Under it, no one transaction can give rise to both a bad debt and a loss deduction. Thus if upon payment of a guaranty obligation there is created a valid debt relationship between the guarantor and the primary obligor, the guarantor is entitled to bad-debt treatment only. If a debt relationship does not arise upon payment, the deduction can be allowed as one for loss if incurred either in a trade or business or in a transaction entered into for profit.[2] Prior to the decision in *Putnam*, if a corporate debtor was no longer in existence at the time of the payment of the guaranty obligation, the courts unanimously treated the resultant loss as from a transaction entered into for profit and fully deductible. But if the corporate debtor were legally existent at the time the Tax Court allowed deduction of the loss only as a nonbusiness bad debt.

A deduction for loss may be had only if the loss has not been compensated for by insurance or otherwise. If the payment by a guarantor gives rise immediately to a debt from the primary debtor then loss at payment of the guaranty may be considered "compensated for" by the acquisition of the debt. When the debt then becomes worthless in the hands of the guarantor, he is allowed a deduction for a bad debt only. This was essentially the view of the Tax Court which at the time of presentation of the issue in *Putnam* to the Supreme Court was contrary to the view of the Second, Third, Fifth and Sixth Circuits, but in accord with the Eighth Circuit view.

Primary debtor no longer exists

Paradoxically the source for the majority Courts of Appeals' view was a Tax Court case. In *Abraham Greenspon*,[3] the taxpayer had orally guaranteed certain loans to a corporation in which he had a financial interest. Later, when the corporation was not only insolvent but had been completely liquidated and had ceased to exist, the taxpayer was required to fulfill his guaranty. The Tax Court held that petitioner was entitled to a deduction not for a bad debt but rather for a loss from a transaction entered into for profit. The Court indicated that since the principal debtor corporation was no longer in existence, no debt could arise in favor of the guarantor and thus the loss upon payment of the guarantee was not compensated for.

Subsequently in *J. B. Book*,[4] the same basic view was expressed. There the taxpayer had guaranteed the obligations of a testamentary trust. The trust lost all of its assets through foreclosure, and "ceased to exist." Afterward in a compromise, the taxpayer made payment on his guaranty. The Tax Court concluded that a bad-debt deduction was not allowable but indicated that a loss deduction might have been proper.

But later in *Agnes I. Fox*,[5] the Tax Court held that the taxpayer sustained a nonbusiness bad-debt loss. As an accommodation the taxpayer had loaned her husband certain securities to be used as collateral on his personal brokerage account. When additional collateral was required by the broker, the taxpayer refused to loan her husband more securities, but signed a guaranty of the account. The husband died, and his estate was insufficient to meet his obligation. As a consequence, the taxpayer had to make good her guaranty. The majority of the Tax Court concluded that the debtor was in no way discharged of his obligation by death and that his insolvency at the time of death and the insolvency of the estate at the time of payment on the guaranty only went to the worth of the debt acquired by the taxpayer upon payment of her guaranty. Judge Arundell, the writer of *Greenspon*, dissented on the ground that it was highly "specious" to him to hold that the taxpayer received a "theoretical claim" against her husband's estate which compensated her for her loss when the husband had been dead for seven years, his estate was insolvent at the time of payment and the executors of his estate had been discharged. The lone dissenter felt that the *Fox* case should have been treated like *Greenspon*.

On appeal, the Second Circuit reversed mainly along the lines drawn first in *Ingersoll*, *Greenspon* and *Book*, holding that the taxpayer was entitled to a loss deduction from a transaction entered into for profit. The court pointed out that it was "utterly unrealistic to consider the payment as one made in any expectation of recovery over or of any legal claim for collection," but nevertheless concluded that its holding "does no violence to the theory that a debt might arise upon payment by a guarantor where the principal debtor remains still in existence."

Primary debtor in existence

The Third, Fifth and Sixth Circuits in essence followed the tenor of the *Fox* decision, (except for the last-quoted statement, which is perhaps the crucial point) and by a somewhat strained literal interpretation of the language of the bad-debt provision came up with what was often considered the more realistic approach to the problem. In *Pollak v. Commissioner*,[6] the taxpayer, a stockholder and officer, guaranteed certain bank loans made to the corporation. A short while before the corporation filed a petition for reorganization under the Bankruptcy Act the taxpayer was called upon to satisfy his guaranty. The assets of the corporation were subsequently sold pursuant to the plan of reorganization. The Tax Court held that when Pollak made payments on his endorsement the corporation, which was still in existence, became indebted to him under the doctrine of subrogation. The Third Circuit reversed. While indicating that the Tax Court was correct in a technical sense in saying that under the doctrine of subrogation the corporation became indebted to Pollak for the payments made by him on his endorsement and guaranty, it expressed as its

sification as a loss or bad debt is immaterial, since the resultant tax treatment is the same.)

The critical issue arose with respect to whether an unrecovered payment made by a stockholder or officer-guarantor or other such secondary obligor, at a time when the primary corporate obligor was still in existence but insolvent, was properly deductible as a loss from a transaction entered into for profit, as generally contended for by taxpayers, or only as a non-business bad debt, as usually determined by the Commissioner.

[3] 8 TC 431 (1947). See Ingersoll, 7 TC 34 (1946).
[4] 8 TCM 101 (1949).
[5] 14 TC 1160 (1950).
[6] 209 F2d 57.

rationale the view that Pollak had fulfilled his legal obligation under his endorsement and guaranty, undertaken for profit by protection and enhancement of his investment in the corporation, without any realistic expectation of repayment upon a technical debt due him from the then insolvent corporation. The court believed that its view was supported by the *Fox* decision and dismissed as irrelevant the fact that in *Pollak* the corporate debtor was still in existence at the time of payment of the guaranty, (in *Fox* the principal debtor was deceased). The court reasoned that in both cases the payment had been made under a pre-existing legal commitment, that in neither was there any expectation of reimbursement, and that in each the debt which arose under the doctrine of subrogation was "substantially uncollectible from the time it arose." The court appears to have ignored the Second Circuit's own pronouncement in *Fox* that it was leaving intact the principle that a debt might arise when the primary debtor was still in existence.

Reasoning behind Pollack

In *Pollak*, the Third Circuit was holding, in effect, that the loss upon the guaranteed payment was not in any real sense compensated for; the debt, if it was such at all, had been worthless when acquired. The court further held that the so-called debt could not be considered as one which "becomes worthless within the taxable year," as required by the bad-debt provisions, because it was already worthless when it first arose. Thus the court posed a problem in semantics as to being and becoming. But the statute did not and does not require that the debt have been valuable first and at sometime thereafter within the taxable year have become worthless. The function of this phrase can be understood by recalling that it was part of an Act intended to provide an objective standard for worthlessness in contrast to the pre-1942 standard of "ascertainment."

In support of its holding in *Pollak* that the debt due by the principal debtor was not deductible as a bad-debt because it was worthless when acquired, the Third Circuit relied on *Eckert v. Burnet*[7] and *Helvering v. Price*.[8] But the *Eckert* case held only that a cash-basis taxpayer does not incur a loss in the taxable year in which he merely exchanged his own note for the corporation's obligation, upon which he was secondarily liable, regardless of whether or not the debt was worthless when acquired. The strict holding of the Court in *Eckert* then was only that the taxpayer could not take any deduction until he paid the note. The *Price* case merely reasserted the precise rule of the *Eckert* case, making it absolutely clear that the *Eckert* view was applicable to both a bad-debt deduction and a deduction for a loss. In both instances, a cash-basis taxpayer must have paid out cash or its equivalent before possibly being entitled to a deduction.

Not long afterward in *Peter Stamos*,[9] the Tax Court, mindful of the *Pollak* decision, declined to follow the Third Circuit view. It clearly indicated that in its view if the corporation debtor is still in existence, even though insolvent at the time of payment upon a guaranty, a debt arises in favor of the taxpayer and any loss therefrom is governed solely by the bad-debt provisions. *Greenspon*, *Ingersoll* and *Fox* were each distinguished on the theory that in those cases no debt arose in favor of the guarantor, because the principal debtor was no longer in existence at the time the guarantor satisfied his obligation.

Thereafter, the Fifth Circuit in *Edwards v. Allen*,[10] followed *Pollak* and expanded somewhat on the *Pollak* interpretation of the *Eckert* case. And not long after that the Sixth Circuit had its chance to speak out in *Cudlip v. Commissioner*.[11] There the taxpayer had guaranteed the note of a corporation in which he was a stockholder. The corporation failed, and the taxpayer had to satisfy his guaranty obligation. Payment under the guaranty was made while the corporation was still in existence but at a time when it was insolvent. The Court divided. The majority held, on the basis of the *Pollak* and *Allen* cases, that the taxpayer was entitled to a deduction for loss from a transaction entered into for profit.[12]

The lone dissenter in the Sixth Circuit, Judge Steward, would have strictly applied the doctrine of subrogation. Recognizing that the debt arising as a consequence would usually be worthless at the time of acquisition, he would nonetheless have limited deduction to one for a bad debt. He pointed out, that the catch phrase "that a debt worthless when acquired cannot later become worthless" is really a shorthand way of saying that in certain cases where the deduction is not allowed it is because the seeming debt was in reality a gift or contribution and not a valid debt at all.

Finally, the Eighth Circuit handed down its decision in *Max Putnam*. The facts there were simple: the taxpayer had to make good as co-maker or guarantor on a bank note of the company in which he was interested. The court held simply that the payment gave rise ultimately only to a nonbusiness bad debt and not a loss deduction, without any doctrinal explanation.

Supreme Court and Max Putnam

The Supreme Court placed considerable emphasis upon the operation of the doctrine of subrogation, stating that:

"The familiar rule is that *instanter* upon the payment by the guarantor of the debt, the debtor's obligation to the creditor becomes an obligation to the guarantor, *not a new debt, but, by subrogation, the result of the shift of the original debt from the creditor to the guarantor who steps into the creditor's shoes.* Thus, the loss sustained by the guarantor unable to recover from the debtor is by its very nature a loss from the worthlessness of a debt." [Emphasis supplied.]

The Court noted that such had long been the generally understood rule until the decisions of the courts of appeals in conflict with the decision of the Eighth Circuit. At this point the Court carefully, though nevertheless rather strangely, states that: "The Congress recently confirmed this treatment in the Internal Revenue Code of 1954 [166(f)] by providing that a payment by a noncorporate taxpayer in discharge of his obligation as guarantor of certain noncorporate obligations 'shall be treated as a debt.'" And inasmuch as the loss upon a bad debt may, under the *Spring City* rule, be deductible only "as such or not at all," and it having been conceded that the

[7] 283 U.S. 140.
[8] 309 U.S. 409.
[9] 22 TC 865.
[10] 213 F2d 794.
[11] 220 F2d 565.
[12] As did the other courts of appeals, the Sixth Circuit undertook further analysis of the *Eckert* and *Price* cases. The majority said quoting from the *Allen* case that:

"If a debt worthless when acquired cannot be said to 'become worthless' in the hands of the taxpayer if voluntarily acquired, no reason appears why it can be said to 'become worthless' in the hands of the taxpayer when involuntarily acquired."

But as I pointed out in a lecture before the 1955 American University Tax Institute, "a distinction does exist between the two situations as is evident from the purpose of the simple rule that voluntary acquisition of a worthless debt cannot give rise to a deduction for a bad debt. That principle standing alone prevents a taxpayer from creating for himself a right to a reduction by making an advance or payment without reasonable expectation of repayment. Where the obligation to make the advance is in-

loss was not from a business bad debt, Putnam was consequently entitled only to a nonbusiness bad-debt deduction on the transaction.

The Court considered fully the premises upon which the majority circuits based their view and concluded that they were erroneous.

(1) A clear distinction is drawn between the involuntary acquisition of a worthless debt by subrogation, and the voluntary acquisition of a worthless debt which is "no valid debt at all." The latter is a gift.

(2) The Court affirmatively asserts that if the doctrine of subrogation is properly understood then there can be no doubt that the subrogee's debt "becomes" worthless even though it is seemingly worthless at the moment of origin.

"This misconceives the basis of the doctrine of subrogation, . . . Under the doctrine of subrogation, payment by the guarantor . . . is treated not as creating a new debt and extinguishing the original debt, but as preserving the original debt and merely substituting the guarantor for the creditor. The reality of the situation is that the debt is an asset of full value in the creditor's hands because backed by the guaranty. The *debtor is usually not able to reimburse the guarantor and in such cases that value is lost at the instant that the guarantor pays the creditor. But that this instant is also the instant when the guarantor acquires the debt cannot obscure the fact that the debt 'becomes' worthless in his hands.*" [Emphasis supplied.]

It is significant that the Court took pains to indicate that even if its view of subrogation was not correct, its conclusion would be unaltered—"apart from the fact that if it were true that the debt did not 'become' worthless, the debt nevertheless would not be regarded as an ordinary loss under Section 23(e),"

curred prior to the making of the advance and at a time when the guarantor's expectation is that such advance will not have to be made, and where the making of the advance is in accordance with the obligation and thus involuntary, there is no possibility of creating a bad-debt deduction for oneself without reasonable expectation of repayment. Expectation of repayment here should not refer to probable repayment if called upon to make good on the guarantee because in most instances it will be assumed that the primary debtor will likely be insolvent at that time—in fact the insolvency of the primary debtor is usually the very reason the guarantor is called upon to satisfy his obligation—but rather should refer to the expectation at the time of borrowing or undertaking the guarantee that the basic loan will be repaid. This view accords with the Tax Court decision in *Aftergood*, 21 TC 60, and is not inconsistent with that Court's decision in *Caroline Thompson*, 22 T.C. 507, since there, at the time the taxpayer purchased the claims in issue, the estate against which the claims were held was insolvent and the taxpayer could have had no reasonable hope that the claims would be paid in full."

under the important *Spring City* rule.

(3) Lastly, the Court faced the *Eckert* issue head-on: it stated that the opinion in that case "did not imply a determination by this Court that the guarantor's loss was not to be treated as a bad debt. This Court was not faced with the question in *Eckert*. *The point decided by the case was that a guarantor reporting on a cash basis and discharging his guaranty, not by a cash payment, but by giving the creditor his promissory note payable in a subsequent year, was not entitled to a bad debt loss deduction in the year in which he gave the note.* The true significance of the [oft] quoted language is that although 'the debt was worthless when acquired' it could not 'be charged off' within the taxable year as the *promissory note given for its payment was not paid or payable within that year.*" [Emphasis supplied.]

The future importance of Putnam

Having effectively disposed of each legal contention raised against treatment of a guarantor's loss as a nonbusiness bad debt, and having safely grounded its opinion on accepted tax and general legal principles, the Court appears to find further comfort in the expression of a broad policy view which may well represent one of the most significant and lasting aspects of the case. First, the majority of the Court points to the objective of the Revenue Act of 1942 to minimize "the revenue losses attributable to the fraudulent practices of taxpayers who made gifts to relatives and friends disguised as loans." But this well-known bit of tax history is only a stepping-stone to what comes close to being something of a *tour de force*: "Equally, however, the [Act] was suited to put nonbusiness investments in the form of loans on a footing with other nonbusiness investments." Support is sought for the proposition in a careful selection of broad statements from the legislative history.

"The proposal originated with the Treasury Department whose spokesman championed it as a means 'to insure a fairer reflection of taxable income,' and the House Ways and Means Committee Report stated that the objective was 'to remove existing inequities and to improve the procedure through which bad-debt deductions are taken.' We may consider Putnam's case in the light of these revealed purposes. His venture into the publishing field was an investment apart from his law practice. The loss he sustained when his stock became worthless as well as the losses from the worthlessness of the loans he made directly to the corporation would receive capital loss treatment; the 1939 Code so provides as to nonbusiness losses both from worthless stock investments and from loans to a corporation, whether or not the loans are evidenced by a security. It is clearly a 'fairer reflection' of Putnam's 1948 taxable income to treat the instant loss similarly. There is no real or economic difference between the loss of an investment made in the form of a direct loan to a corporation and one made indirectly in the form of a guaranteed bank loan. The tax consequences should in all reason be the same, and are accomplished by Section 23(k)(4)."

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Justice Harlan's dissent

Note, however, that Mr. Justice Harlan, the lone dissenter, is quick to point out the inherent difficulty in going back to and relying on the 1942 Act for support of that view. He states:

"Section 23(k)(4) created a new category of debt losses, namely, 'nonbusiness debt' losses, which were thenceforth to be given capital loss treatment instead of the full loss deduction therefore accorded them. . . . it seems to me that the House Ways and Means Committee Report on the bill shows that Section 23(k)(4) was aimed at a specific narrow objective, namely, that of reducing revenue loss from the deduction of 'family' or 'friendly' loans which were in reality gifts. . . . I am unable to find in this, or in any of the other legislative history to which the Court refers, any clear intimation of a broad policy to analogize generally all types of nonbusiness loans to other forms of capital investment, still less anything which indicates that guarantors' losses were considered as falling within the new section."

It would seem that there can be deduced from the statutory structure both objectives: restriction of the deduction for "friendly" loans, and treatment in like manner of losses which are economically alike. Perhaps it was unnecessary for the Court to rely upon debatable legislative history for the expounding of a significant philosophy. The position that guaranties are no different

economically from direct loans, and that they are all in essence "investment loans," to be most properly treated under our present Federal income tax structure as short-term capital losses, is not only a tenable position but a thoughtful one. It has sound economic sense and needs no flimsy bolstering from ambiguous and vague or at least arguable legislative history. And much the same criticism is applicable to the inferences drawn by the majority from the introduction in 1954 of Section 166(f) into the statute.

Questions Putnam doesn't answer

The *Putnam* case, while in the main a very complete expression of view, does leave several questions or issues not clearly resolved. In *Putnam*, the "corporation still had a corporate existence at the time of the payment [of the guarantee obligation] but had ceased doing business and had disposed of its assets eighteen months earlier." What if the corporation was not legally in existence? The Tax Court view was that the taxpayer is allowed a loss from a transaction entered into for profit on the theory that no valid debt can arise by subrogation once the primary obligor ceases to exist.

In the first part of its *Putnam* opinion, the Supreme Court appears to follow strictly the theory of "subrogation," interpreted as the stepping-into the-shoes—or, in this instance, the debt—of the old creditor. It might be assumed from this that the Supreme Court would agree with the Tax Court on the ground that there was no one against whom a right by subrogation might exist. But such a rule gives undue importance to the irrelevant detail of the existence of the primary debtor at the time of payment by the guarantor. It has had the dangerous effect of putting primary emphasis on timing the payment of the guaranty and liquidation of the corporation.

At the close of its opinion, however, the Supreme Court states quite broadly that: "There is no real or economic difference between the loss of an investment made in the form of a direct loan to a corporation and one made indirectly in the form of a guaranteed bank loan. The tax consequences should in reason be the same, and are accomplished by Sec. 23(k)(4)."

And in a footnote following the above-quoted citation to the statutory provision, the opinion states: "Upon this ground, contrary to the holding in *Fox v. Commissioner*, 190 F. (2d) 101, the guarantor's nonbusiness loss would receive short-term capital loss treatment despite the nonexistence of the debtor at the time of the guarantor's payment to the creditor."

Thus it would appear that despite any application of the theory of subrogation, the Supreme Court would decide a case involving a loss from a guaranty payment at a time when there was no longer in existence an existing primary debtor on the broad policy ground that guaranty obligations are in essence no different from direct loans and that the treatment to be accorded both should be the same: namely, nonbusiness bad-debt treatment, until Congress clearly provides otherwise.

Indemnity losses

But what then of the ordinary-loss treatment that is generally accorded to a loss sustained upon the satisfaction of an indemnity contract. An indemnitor (unlike a guarantor) has no right to subrogation in the absence of a specific agreement for subrogation. There may be a conceptual difference between a guaranty and an indemnity obligation, in the sense that the latter is generally thought of as somewhat more like an insurance for the direct lender and a final resting place for the loss. But any such difference is not significant from an economic point of view. The losses are economically akin.

The *Putnam* decision sheds little light here. If there is no right of subrogation, how will it be possible to bring the loss within the scope of the debt provisions in view of the *Spring City* rule of mutual exclusiveness? Yet the Court has committed itself to a policy of like treatment for like losses and treatment of those losses from "investment loans" as nonbusiness bad debts.[13] It should also be noted that much the same type of problem may face the Court in the future in cases arising under the law of subrogation in states in which a debt by subrogation is precluded until the creditor's full claim has been paid. If the guarantor pays less than the loan guaranteed, the guarantor does not acquire a debt by subrogation, and the bad-debt provisions seemingly would not be applicable. Would such a result be appropriate in view of the board principles and philosophy expressed by the Court in *Putnam*?

The reasoning of the Supreme Court in *Putnam* obviated the necessity for considering another issue which was inherent in the case, and which will contitnue to have significance in the area.

Despite the differences between the Tax Court and the majority Courts of Appeals in treatment of guaranty losses, these courts were in accord regarding the view that the undertaking of a guaranty obligation constituted "a transaction entered into for profit," the Tax Court so holding without discussion whenever it allowed deduction of a guaranty loss as an ordinary-loss deduction under then Section 23(e)(2) if the corporation which was the primary obligor was no longer legally existent. The decision of the Eighth Circuit, however, came very close to holding, if it did not in fact hold, that the mere undertaking of a guaranty obligation or an endorsement, without specific and direct compensation for the undertaking of the guaranty obligation or the endorsement, did not, or at least did not necessarily, constitute a "transaction entered into for profit."

In view of the holding of the Court in *Putnam*, the issue is no longer significant with respect to the deduction of the guarantor's loss. Such losses are deductible only as bad debts. The question remains significant, however, if the secondary obligation is in the form of an indemnity contract. In essence, the issue is whether the "profit" in a transaction entered into for profit must be a direct profit attributable to the actual undertaking of the secondary obligation, or whether it is sufficient if the ultimate profit is to be reaped indirectly through the accretion in value of corporate stock (in the case of a stockholder indemnitor), or otherwise indirectly through the success of the business enterprise. While the Tax Court has never discussed the issue, the court of appeals in *Allen v. Edwards* rejected a contention that the guaranty of corporate loans by stockholders was not a transaction entered into for profit. It stated that "this contention is so clearly at variance with what seems to us to be a common everyday interpretation of simple language,

[13] And the court has in so holding relied in part on Section 166(f), which undertakes to join specifically those guaranty losses covered with similarly incurred losses upon satisfaction of an indemnity contract. Here then, in view of the significance attributed by the Court to 166(f) may be a helpful relationship. But paradoxically, or perhaps significantly, while such like losses are joined in treatment under the bad-debt provisions, the losses qualifying under 166(f) are deductible in effect as business bad debts—fully deductible, contrary to the treatment accorded guaranty losses under the *Putnam* decision.

[14] 217 F2d 252.

that clear and convincing authority in support of this contention would have to be brought forward . . . to support such construction."

And in the *Pollak* case the Court stated: "we all know that a stockholder who thus loans his credit to a corporation does so in the hope and expectation that the corporation with the additional credit thus made available to it, will succeed in preserving or adding to the value of his stock. . . . " In the *Ansley* case[14] the taxpayer sustained a loss upon the sale of bonds which he individually loaned to his corporation to be put up as collateral for a loan to the corporation. Although the court held that the intention of the stockholder in guaranteeing the corporate obligation was to increase the value of his stock and concluded that such intention was sufficient to meet the requirement that the transaction constituted one entered into for profit, the taxpayer had in fact been specifically compensated for loaning the bonds and there could be no doubt that the transaction had been entered into for a profit, indirect and direct. The issue thus remains in conflict and perhaps subject to review in the future.

Section 166(f)

Section 166(f) is new. Added by the 1954 Code, it provides for full deductibility of certain guaranty payments as bad debts. This is accomplished by specifically making inapplicable that part of Section 166 defining and limiting deduction for nonbusiness bad debts. The provisions of 166(f) are applicable in the case of loss upon payments by a noncorporate guarantor, endorser or indemnitor of a noncorporate obligation (1) when the proceeds of the initial loan were used by the borrower in his trade or business, and (2) when at the time of payment the borrower's obligation to the direct lender is worthless.

In many ways this new provision is rather odd. And on the whole it tends to cure fewer ills than it causes. Congress was evidently interested in granting ordinary-loss treatment for such payments, but it did not do so through the loss provisions of Section 165. Rather, as the majority opinion in *Putnam* noted, Congress authorized bad-debt status, but not nonbusiness bad-debt status. It thus achieved, in effect, an equivalent of loss treatment through the bad-debt provisions. Despite the reliance of the majority of the Supreme Court on 166(f) as a reflection of Congressional intent to treat guaranty losses as nonbusiness bad debts, the provision significantly does not deal with corporate obligors. It applies only to cases involving noncorporate guarantors and noncorporate borrowers.

The section does little to vary the result that would have generally obtained otherwise under the circumstances apparently contemplated by the drafters of 166(f). Normally, a noncorporate guarantor of a noncorporate obligation will be either the individual owner of or a partner in the borrower enterprise. His loss is more than likely to have been business connected and fully deductible in accordance with the provisions of 166 or 165 without regard to subsection 166(f). Thus 166(f) treatment is no different from treatment under prior law in the situations probably intended to be covered. However, several unintended consequences may result in other situations.

Section 166(f) may have considerable impact on the basic principles of nonbusiness bad-debt treatment provided for elsewhere in 166. The nonbusiness-bad-debt concept and the special treatment of such bad debts was introduced in the Revenue Act of 1942, mainly to limit the benefits of income tax deduction in the case of gratuitous personal and family loans. Section 166(f) limits the effectiveness of this general objective, since its applicability is not in any way determined by the relationship of the transaction to the guarantor's trade or business. Thus a family or personal guaranty type of loan, not connected with any trade or business as far as the guarantor is concerned, may now qualify for business bad-debt treatment if the proceeds of the original loan from a third party were used in the borrower's trade or business. To the extent that 166(f) may have been intended to save from nonbusiness bad-debt treatment only a guaranty loss from a transaction entered into for profit, the provision is ineptly drawn. It eliminates in one special instance, which has no special quality to recommend it, the general rule limiting full deduction for bad debts to those connected in an appropriate way with a trade or business.

Relation of debt to trade or business

In the lower courts, Putnam contended that even if his deduction was limited to a bad debt, the loss should be considered as a business bad debt on the ground that the payment of the guaranty was proximately related to the conduct of a trade or business. The Tax Court and the Eighth Circuit disagreed and carefully pointed out that the guaranty and the loss sustained upon payment of the guaranty in no way related to a business being conducted by Putnam. This issue was finally conceded before the Supreme Court. We thus have no expression by the Supreme Court concerning what constitutes the carrying on of a trade or business or the requisite relation that must exist between a debt or the loss therefrom and the trade or business to which it is being related. Such issues, however, will now necessarily be raised more frequently as claim is made for *business* bad-debt treatment of guaranty losses.

Conclusion

The problem thus seems to me essentially the same as it was prior to the *Putnam* decision. As I said at the 1955 American University Tax Institute, "the difficulty is not one of difference in interpretation by the courts. The difficulty is the difference in treatment under the Code of essentially like losses. Congress should undertake a complete re-examination of the entire area. It should select the basic mode of tax treatment to be accorded the 'loan investment,' and then develop rules under which each like case can be treated in a single coherent way." ☆

Holzman warns not to ignore accumulated earnings threat

WE DON'T SUPPOSE that Professor Robert S. Holzman[1] set out to scare anyone, but in his new book *The Tax on Accumulated Earnings*[2] he makes quite a point of the high tax cost to corporations and stockholders if they fall afoul of Sections 531-7 (affectionately known to old-timers as "Section 102"). And he mentions liability of directors for permitting the corporation to suffer through mismanagement of this tax matter.

Actually, he does say in his preface that "An important purpose of this book will be to dissipate the feeling that has sprung up in many quarters that the teeth of the accumulated earnings tax have been drawn by the 1954 Code.

[1] Of taxation at NYU Graduate School of Business Administration.
[2] Published by The Ronald Press Co., New York, 6 x 9 inches, 106 pages plus appendix. $10.

Except for very small corporations, that is definitely not the case. Almost all the pre-1954 dangers still exist; and as far as management is concerned, there is now a new peril that is perhaps the most serious one of all: overcomplacency."

He then goes on to discuss the problem in general, to cite reasons for retention of earnings and cases where these reasons have stood up, and steps to be taken to avoid imposition of tax.

Of the 136 pages, 106 are devoted to discussion, the remainder to text of the statute, tables of cases and rulings, bibliography, and index. All of this material will be extremely useful to the person who really wants to get at the subject; for "the man with the problem" the $10 cost for some 100 pages of text would undoubtedly be well worthwhile.

Incorporating the going business: how to find the method with the least tax cost

by GERALD J. KAHN

Rules governing taxability of incorporation of a business grow more rigid and specific with each change in the statute and case law. Avoiding tax penalties is now a matter of walking a very straight line. This article analyzes tax-free v. taxable incorporations, the use of boot, handling of inventories and depreciable assets, avoidance of Section-306-stock, control of the corporation, and other items that determine taxability. Mr. Kahn's discussion here is based on a paper written for the Seventh Annual Tax School of the State Bar of Wisconsin.

AFTER A DECISION to incorporate a going business has been made, the incorporators will be confronted with the myriad tax problems involved in the organizing and capitalizing of a new corporation. First, should the creation be a taxable or a nontaxable transfer?

The ground rules for a nontaxable transfer to a new corporation are in Section 351 of the Internal Revenue Code. The transferors of property to the new corporation must receive only "stock or securities" in exchange. The statute does not define "stock or securities," and the Regulations, except for excluding stock rights and stock warrants, say nothing on this subject. The tax adviser must therefore resort to court decisions to ascertain whether a certain instrument qualifies as "stock or securities" and obviously the problem centers about the meaning of "securities".

Perhaps at the risk of oversimplification, the rule may be stated that long-term, as opposed to short-term obligations such as bonds, debentures or notes, constitute "securities." If a dividing line can be drawn between short- and long-term obligations, conservative judgment would probably require that it be at least ten years. For the sake of caution, it might be well to have the obligation in the form of something other than an ordinary promissory note, because some courts have been reluctant to treat notes as securities, regardless of the term of the obligation.

Section 351 also requires that the stock or securities be issued for property, and it goes on to state that services shall not be considered as property. But caution is in order if stock or securities are issued for services and property at the same time. As previously noted services do not constitute "property." If the stock is to be divided equally between two persons, one getting his share for assets, and the other getting it for services, Section 351 will not apply. This is because the statute provides that the transferors must be in control of the corporation immediately after the exchange. According to Section 368(c), control is ownership of at least 80% in voting power of the total *issued* voting stock and 80% in number of the total issued non-voting stock.

Under the 1939 Code it was necessary in an exchange involving two or more transferors that each receive stock in proportion to his interest in the property transferred. This ratio is no longer necessary. But if there is a disproportionate issuance of stock, there may be a gift, the payment of compensation or the satisfaction of an obligation as between the transferors, and their tax consequences must be considered.

With certain exceptions, the nontaxable nature of a transaction will not be disturbed by the assumption of liabilities or by the taking of property subject to liabilities by the corporation. If the purpose is to avoid taxes or if there is no bona fide business purpose, the transaction can be taxable to the extent of the liabilities assumed. When and where these exceptions will be applied is uncertain at this date.

The statute expressly imposes a tax if the liabilities assumed are in excess of the basis of the transferred assets. This tax (on the excess) can, of course, be avoided by transferring more assets or reducing the liabilities to the extent of the excess.

Taxable transfers

At times a taxable transfer is desirable. If a taxpayer has substantial capital losses in a year he is organizing a new corporation, he may desire a capital gain to offset such losses, since the maximum offset of capital losses against ordinary income in any year is $1,000.

In a nontaxable transaction, the transferred assets retain the tax basis they had in the hands of the transferor. But in a taxable transaction, it may be possible to step up the basis of inventory or assets subject to depreciation. The resulting increase in depreciation or cost of goods sold will of course reduce taxable profits.

If, in a taxable transfer, the market value of assets is less than their basis, a loss is available to the transferor, provided he does not own more than 50% of the transferee's stock.

A taxable transfer is achieved by failing to meet the control requirement or by issuing "boot" (consideration other than stock or securities). The uncertainty which can develop from valuing assets can make the "failure-to-have-control" method objectionable. In addition, a transaction designed to fall just short of the 80% control requirements (i.e., acquisition of 79% control) would probably be questioned by the Service. The courts, however, have indicated that they will support the taxpayer on this question.

The uncertainties of valuation and just missing control are avoided for the most part in a "boot" transaction. Because gain is limited to the amount of

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"boots" it can be determined in advance. The danger in this method is that the Government may destroy or limit the tax benefits by allocating the gain to nondepreciable assets such as land or goodwill.

In the event that the exchange results in a loss, "boot" should not be used because Section 351(b) expressly negatives the recognition of loss where the transaction is taxable by virtue of the receipt of "boot."

Timing the incorporation

Incorporation of a new business should be deferred until the business is operating profitably. Its losses might be used to offset other profits of the proprietors. Incorporation of a profitable business should take place at the time of the year which would permit the profits until incorporation to be taxed at individual rates that are lower than the corporate rates.

Assets to transfer

A change in accounting method upon incorporation raises some problems. If the business reported on the accrual basis and the new corporation follows the cash method, uncollected accrued income at the time of incorporation might be taxable to both the old business and the new corporation. This situation can be avoided by not transferring the receivables. On the other hand, if the unincorporated business is on the cash basis and the corporation is on the accrual basis, accrued deductions at the time of incorporation might not be deductible by either. Payment of all debts before incorporation would solve the problem in a situation of this kind.

Some attention should be given to the matter of what assets should be transferred to the new corporation. Only those assets that are actually needed in the business should be transferred in order to avoid the risk of an unnecessary tax upon redemption or liquidation. The transfer to a new corporation of installment receivables or completed contract receivables will result in an immediate tax to the new corporation where the business reported on an installment or completed contract basis. Unless this is the result desired, these assets should be kept out.

Planning stock for withdrawal

A corporation can be financed by equity capital or by a combination of equity and debt capital. Common stock possessing voting rights is important from a tax standpoint in connection with Section 302(b)(2). Section 302 lays down the rules by which a stockholder may withdraw funds from a corporation at capital gain rates through a redemption of all or part of his stock. One way is by a substantially disproportionate redemption as defined therein. However, in order to qualify as a disproportionate redemption there must be a redemption of voting common stock. One of the requirements of Section 302(b)(2) is that the stockholder own less than 50% of the voting stock after the redemption. Hence a small issue of voting common will enable the corporation to redeem a small number of shares and still have the stockholder meet the statutory test.

Nonvoting common stock can be very useful some day in effectuating a family gift or estate plan or providing a means for employee stock ownership without sacrifice of control by the principals. Nonvoting common can be redeemed with voting common as part of a qualified disproportionate stock-redemption plan, although one where nonvoting common alone were redeemed would not so qualify.

Preferred stock may be desirable for the same reasons as nonvoting common stock, and it also may be used to depress the price level of the common stock to make it attractive to executives as an investment for incentive reasons. If it is possible that preferred stock might be favored some day, it should be issued upon incorporation before the corporation has earnings. If it is issued later, it may be classed as Section 306 stock which, suffice it to say, carries with it the potential disadvantage of being taxed as ordinary income upon a subsequent sale or redemption.

Preferred stock is now being issued in many instances at a "discount." This is because the difference between the issue price and redemption value will be taxed at capital gain rates on redemption.

Advantages of debt

As we have seen "securities," in the form of long-term corporate obligations may be issued along with stock in a Section 351 exchange. Interest payments are deductible and so provide a means of placing corporate income into stockholders' hands without incurring a double tax. Since payments of principal are tax-free, a stockholder may recover part of his capital without facing the adverse consequences of a stock redemption. If the business should fail, the stockholder as a creditor will have a bad-debt deduction either business (deductible in full) or nonbusiness (deductible as a short-term capital loss), but most likely the latter. On the other hand, a worthless stock interest is treated as a long-term capital loss. The existence of a bona fide corporate debt may justify the retention of earnings for the purpose of retiring the obligation. This could certainly be argued as a defense against a charge of unreasonable accumulation of surplus. As in the case of preferred stock, if the company contemplates issuance of debt securities, this should be done at the time of incorporation when there are no earnings. Section 354(a)(2) imposes a tax upon the issuance of debt obligations as part of a subsequent recapitalization.

The debt securities issued upon incorporation must not, as we have seen, constitute "boot." Therefore, instead of transferring an asset such as cash upon incorporation in exchange for a short-term note, it would be better to retain the money and lend it to the corporation at a subsequent time.

The courts have on a number of occasions wrestled with the problem of whether a certain instrument is a debt obligation or an equity obligation. Out of the decisions come a number of tests. Among the factors said to be indicative of a debt obligation are the following:

1. Fixed maturity date and right to enforce payment;
2. Instrument designated as a debt obligation and treated as such on books and records;
3. Fixed interest payments;
4. Not subordinated to rights of other creditors;
5. Stock and debt securities not held in same ratio by same individuals;
6. Debt capital not out of proportion to equal capital.

The "thin corporation" has given rise to most of the problems in this area. Although there is a legion of cases in which this issue has been considered, it is impossible to state where the dividing line is to be drawn. Some commentators claim that a 3½ to 1 ratio of debt to

equity capital is proper while a 4 to 1 ratio is not. At best this is a rule of thumb and a not too accurate one at that. The potential cost to a taxpayer of an adverse decision here is sufficient justification for a conservative approach on this question.

In view of the many pitfalls facing a stockholder who advanced money to his corporation, it became a favorite device to have the corporation borrow from a third party while the stockholder guaranteed the obligation. Several of the Circuit Courts of Appeals had indicated that if the corporation became insolvent and the stockholder honored the guarantee, he would be entitled to a full deduction as an ordinary loss for the payment. The recent adverse decision of the Supreme Court in the *Putnam* case appears to have destroyed this as a tax-saving procedure.

It is obvious that the tax-savings which can be accomplished by proper planning in the organization and financing of corporations demand a conservative and informed approach on the part of anyone advising on this subject. ☆

Tax tips on handling the personal holding company and collapsible corporation

by **CHARLES D. LEIST**

THE BASIC PATTERN of personal holding company taxation has remained essentially unchanged for many years. Corporations which conform to the statutory definition are subject not only to the regular corporate income tax rate of 52%, but, in addition, to the almost prohibitive tax rate of 85% of their undistributed personal holding company income in excess of $2,000. The only tax burden from which such corporations are freed is the "Section 102" tax, incorporated in the Internal Revenue Code of 1954 as Section 531.

The closely held corporation is, of course, the particular type of corporate organization which the personal holding company statute seeks to reach. To fall within the statutory definition set forth in Section 542(a) of the 1954 Code, the corporation must satisfy 2 requirements:

1. *At some time* during the last half of the taxable year of the corporation more than 50% in *value* of its *outstanding stock* must be owned, *directly* or *indirectly*, by or for not more than five *individuals; and*

2. At least 80% of its *gross income* for the taxable year must be *personal holding company income* as defined in the statute.

The stock-ownership requirement involves a number of significant concepts. The ownership contemplated by the statute is more than 50% in *value* of the *outstanding stock*—not a number or percentage of issued shares. The requirement is satisfied if the stated ownership exists in five or less individuals *at any time* during the last half of the taxable year, and the fact that stock ownership is sufficiently diluted at all other times is immaterial. The rules of attribution of Section 544 are applied in determining individual ownership; and the word "individuals" is so defined as to include tax-exempt pension, profit-sharing and stock-bonus trusts and most charitable organizations.

The gross income test

The gross income requirement provides that 80% or more of the gross income of the corporation shall consist of personal holding company income. The latter type of gross income is defined by Section 543 to include dividends, interest, royalties, annuities, net gains from the disposition of stock, securities or commodities, income from estates and trusts and from the disposition of an interest therein, income from certain personal-service contracts or from the sale or exchange of such a contract, and some rents.

Two aspects of the gross income requirement are particularly important:

First, the statutory definition of personal holding company income does not embrace gross income or profit from manufacturing or commercial operations; hence, if the gross income from such operations is 21% or more of the entire gross income of the corporation, that corporation will not satisfy the 80% requirement. Gross income for this purpose is not synonymous with "gross receipts" but is the residual profit left after deducting from gross receipts the cost of goods sold.

Second, only some rents fall within the statutory definition of personal holding company income. For the purposes of the statute, rental income is of two types. Rental income from a shareholder owning 25% or more in value of the outstanding stock is always personal holding company income,[1] and, in fact, is not considered to be rent in the sense that that concept is defined in the statute. Rental income from all other sources falls within the statutory definition of rent, and is held to be personal holding company income unless it constitutes 50% or more of the gross income of the corporation. If "rent" as thus restricted to more or less outside sources is 50% or more of the corporate gross income, then, of course, none of the rent is personal holding company income and the corporation will not meet the 80% requirement.

If, in a particular corporate situation, the corporation fulfills both the stock-ownership requirement and the gross income requirement, it will be subjected to the confiscatory rate of taxation on its "undistributed personal holding company income." This latter concept is not the same as the one utilized in applying the 80% test but, instead, is adjusted taxable income less the deduction for dividends paid provided by Section 561.

With the foregoing principles in mind, the question which we must now ask ourselves is what we can do about it. The following considerations are important in handling that problem:

First and foremost, we must make every effort to keep on top of the situation and to detect the danger of personal holding company liability at the earliest possible time in the taxable year. Any close corporation is potentially subject to the prohibitive tax, particularly if it has some substantial dividend and rental income from subsidiaries or other sources. Often if we are able to detect the danger of the confiscatory liability early enough in the taxable year, we can change the complexion of the corporation's gross income sufficiently to avoid the gross income requirement of the statute. This can be done by increasing gross income from manufacturing or commercial operations, by reducing gross income from dividends, interest or items of that nature, or by increasing the rental income from outsiders so that it is equivalent to 50% or more of the aggregate gross income of the corporation.

Second, we may avoid the personal holding company tax by rearranging stock ownership so that we do not run afoul of the stock-ownership test. It is often, however, extremely difficult for an attorney or an accountant to convince his client that corporate ownership should be diluted. Normally close corporations are closely held as a matter of choice, and usually clients are extremely reluctant to relinquish their control of the corporate venture.

Third, the payment of dividends is, of course, the customary method of avoiding the penalty tax of the taxable year when other more lasting techniques have failed or are impractical. In this connection, it is to be remembered that a "dividends paid deduction" equivalent to the amount of the adjusted taxable income of the corporation will completely prevent the imposition of a personal holding company tax. The most important elements of a "dividends paid deduction" are (1) dividends actually paid within the taxable year; (2) dividends paid within 2½ months after the close of the taxable year; and (3) consent dividends.

Of these three elements, dividends actually paid in the taxable year will necessarily remain the most desirable means of avoiding the tax. Dividends paid in the first 2½ months after the close of the taxable year are not allowed as a part of the dividends paid deduction to the extent they exceed 10% of the dividends actually paid in the taxable year. This circumstance points up again the desirability of keeping a close watch on any corporation particularly susceptible to personal holding company treatment. If there is a danger that the prohibitive tax will be imposed, we should know it, and have appropriate dividend distributions planned long before the end of the taxable period.

As to the consent-dividend technique, that method does not contemplate that any dividends will actually be paid, but only that the stockholders will agree to report as taxable income the amount of the consent dividends *as if they had been paid*. It is a technique usually resorted to when the holding company danger is discovered only after the close of the taxable year and before the corporate returns have been filed.

[1] Section 543(a)(6) of the 1954 Code provides for an exception to this generalization in the case of a corporation which has 10% or less of its gross income from dividends, interest, royalties and the like.
[2] Regs. Sec. 1.341-5.
[3] Regs. Sec. 1.341-2.

Fourth, if all other methods have failed and a determination is made against a corporation (whether by court decree or otherwise) for a deficiency in personal holding company tax, the taxpayer's final resort in endeavoring to avoid the tax is to the deficiency-dividend technique of Section 547. This method has a number of objectionable features. For example, the corporation may have disbursed or reinvested its funds and may not have available the necessary means with which to pay the deficiency dividends. Then, too, this procedure can impose a heavy tax burden on the shareholders, if, as a result of the determination, accumulated personal holding company income for a number of years must be distributed at one time.

Fifth, there, of course, remains one additional method of avoiding personal holding company problems, and that is by effecting a liquidation of the corporation subject to the tax. If that is done, we should, however, be fully aware that except to the extent that the liquidation falls within the scope of Section 381, the transferees of the personal holding company cannot later use deficiency-dividend procedure to avoid corporate liability for prior years. On the other hand, personal holding companies will generally want to take advantage of the special liquidation provisions provided by Section 333. That Code section permits shareholders who receive property distributed in kind to avoid tax on the appreciation in value of that property if a complete liquidation is accomplished within one calendar month. That section is often peculiarly advantageous to a personal holding company, since it normally will have a very small amount of accumulated earnings, and at the same time will have substantial unrealized appreciation of its assets.

Collapsible corporations

The reference to Section 333 provides us with a convenient method of introducing the subject of collapsible corporations for that enigma of the tax law ordinarily cannot avail itself of the benefits of Section 333. While the typical security holding company will not be a collapsible corporation unless it holds stock in another corporation which is itself collapsible, certain types of personal holding companies with personal-service contracts may be adversely affected not only by Section 541 but also by the collapsible corporation provisions. Furthermore, anyone seeking to avoid the personal holding company tax burden by the rental-income route should be aware that rental property is a Section 341 asset, the purchase of which creates collapsible-corporation problems.

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It is a general principle of the tax law that gain realized upon the sale of corporate shares or upon the liquidation of a corporation is capital gain. In the years prior to 1950 this principle had been abused by certain segments of the movie and construction industries which sought by use of the corporate form to convert ordinary income into capital gain. To stop this abuse, Congress first enacted in that year the collapsible-corporation provisions. Those provisions have since been amended and expanded, and appear as Section 341 of the 1954 Code.

Section 341 carves out an exception to the general principle previously stated in that it provides that, subject to the limitations hereafter discussed, gain from the sale of stock of a collapsible corporation and gain from a liquidation of, or a capital distribution by, a collapsible corporation shall be treated as ordinary income. The difficulty with Section 341 is that its provisions are so loosely and broadly framed that it subjects to collapsible-corporation treatment many legitimate manufacturing and commercial corporations which should not be controlled thereby.

In order to appreciate the scope of Section 341, we should first discuss the expression "Section 341 assets." Section 341 assets are, briefly speaking, noncapital assets held *for less than three years*. Such noncapital assets consist of (1) stock in trade and inventory; (2) property held primarily for sale to customers; (3) real property and depreciable property used in a trade or business; and (4) unrealized receivables and fees. The last named class of property is in turn defined as untaxed rights to income derived from services or from the sale of other types of Section 341 assets.

With that in mind let us examine the statutory definition of a collapsible corporation contained in Section 341(b). It

is there provided that a collapsible corporation is a corporation *formed or availed of principally:* (a) For the manufacture, construction or production of *property; or* (b) For the purchase of *Section 341 assets;* such activity being undertaken, (c) with a view to collapse of the corporation *before it realizes a substantial part of the taxable income* from the property manufactured, constructed, produced or purchased, *and* (d) with a view to the realization by its shareholders of the gain attributable to such property.

Implicit in the foregoing definition are a number of significant concepts. To be affected by Section 341 it is not necessary that a corporation be formed for the collapsible activity; the test is met if any existing corporation is "availed of" for that purpose. In this connection, the statute states that the collapsible activity must be the principal activity. But the Regulations indicate that this expression will be broadly construed to include any collapsible activity which is "substantial in relation to the other activities of the corporation."[2]

The remaining requirements of the statutory definition relate to (1) the collapsible activity and (2) the intent with which it must be undertaken. The collapsible-activity requirements are set forth as items (a) and (b) above. With respect thereto, it should be noted that "property," the manufacture, construction or production of which may lead to collapsible treatment, is not necessarily a Section 341 asset. It is any property capable of being manufactured, constructed or produced, whether it is a Section 341-type asset, and whether it is held for more or less than three years. The expression "Section 341 assets" is only important to the definition of collapsible corporations when we are concerned with the "purchase" of property.

As to the requirement of intent set forth as items (c) and (d) above, the significant provision is the substantial-income test. Regulations indicate that the requisite intention exists whenever the collapsible action is a "recognized possibility" at any time during the manufacture, construction, production or purchase of property.[3] It is believed further that the Commissioner will insist that a substantial part of the taxable income will not be derived from the property until approximately 50% of the taxable income therefrom has been realized.

In light of the foregoing principles, we can see that a collapsible corporation is by definition a corporation:

(1) which has manufactured, constructed, produced or purchased certain property with the requisite intent; and

(2) in which the activity thus undertaken is either the principal or a substantial activity of the corporation.

The latter requirement will generally be determined as of the time when the corporate stock is sold or the corporation is either liquidated or makes a capital distribution.

Avoiding the "collapsible" taint

Although the statutory concepts are in many respects vague and obscure, Section 341(d) suggests three methods of avoiding the ordinary income result contemplated by the statute, even though the corporation is a collapsible one.

1. It provides that Section 341 will not apply with respect to the gain of any shareholder *unless* at some time at or after the commencement of the manufacture, construction, production or purchase of property, he owns directly or indirectly more than 5% in value of the outstanding stock of the corporation, or owns stock that could be attributed to another shareholder who would then own more than 5% of the outstanding stock. Thus it is clear that an unrelated shareholder who owns 5% or less in value of the corporate stock need never fear the ordinary income treatment prescribed in Section 341. It follows also that if a collapsible corporation has 20 unrelated shareholders, each of whom owns only 5% in value of the corporate stock, all of its shareholders can freely dispose of their shares or participate in a liquidation of the corporation, upon a capital gain basis. It might also be added that a company with such diversified ownership need never fear the personal holding company tax, for it fails to meet the stock-ownership test.

2. It provides that Section 341 will not apply to the gain recognized to shareholders in a collapsible corporation unless more than 70% of such gain is attributable to the collapsible property —that is, to the property manufactured, constructed, produced or purchased. It follows therefore that if 30% or more of the gain realized upon the sale of stock or upon the liquidation of the corporation is attributable to corporate property which is not collapsible property, then none of the gain realized by a shareholder is ordinary income regardless of the proportionate interest owned by him. Property which is not collapsible property will generally consist of such items as: (a) cash; (b) purchased capital assets; (c) Section 341-type assets which have been purchased and held for more than three years; or (d) manufactured, constructed, produced or purchased property with respect to which there has been a substantial realization of income. In this connection, it should be noted that any corporation which is in danger of being treated as collapsible should accumulate its earnings and retain them in a form that cannot be considered as collapsible property. The effect of this provision may, therefore, be to encourage the very thing which Section 531 (relating to the accumulated earnings tax) was designed to discourage.

3. It provides that any shareholder in a collapsible corporation will not have taxed as ordinary income that portion of his gain which is attributable to property held by the corporation for more than three years, regardless of whether such property has been manufactured, constructed, produced or purchased. This principle does not exempt from tax the entire gain realized by the shareholder but only that portion of his gain attributable to the property held for the requisite period. While the three-year rule is particularly advantageous in the case of property constructed or produced, it will not of itself completely insulate from Section 341 the shareholders of many corporations with substantial operating inventories. For example, the manufacturing inventory of an industrial corporation will seldom have been held for three years. Similarly, even if a real-estate-operating company has owned rental properties for 20 years, it may be that it has within three years of the sale of its stock or its liquidation purchased new rental property or extensively remodeled a portion of its

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property, so that the gain derived from its shares is in part attributable to property held less than three years.

These relief provisions must be continuously borne in mind by attorneys and accountants who are consulted in matters of corporate organization, operation and termination. There is, however, one equally important matter which must be emphasized here, and that is that sometimes the dangers implicit in the collapsible-corporation provisions can be completely avoided if better judgment is exercised at the inception of a venture.

One glaring inequity in Section 341 is that it often provides for collapsible treatment of a corporation even though its shareholders would have realized capital gains if they had acquired, owned and sold the property as individuals. For example, suppose a business executive decides to invest his surplus funds in a small office building. To simplify the rental operation, he causes a corporation to be formed in which he owns all the stock and has the corporation acquire the property. In the next year and a half, property values skyrocket in that locality, and he sells his stock for twice his investment. Under such circumstances, it is quite probable that the Service will contend that he has sold the stock of a collapsible corporation, and, therefore, that his gain on the transaction is taxable as ordinary income. Unfortunately, his difficulties in this respect could have been avoided if he had not utilized the corporate form but instead had retained title in himself individually.

In conclusion, a corporation which is a collapsible corporation by definition may not avail itself of Section 337 regardless of whether or not all or a part of its shareholders may take advantage of Section 341(d). Section 337 is that section of the Code which allows a corporation effecting a complete liquidation within a 12-month period to make a tax-free sale of its assets during that period. ☆

New corporate decisions this month

Jury finds loan was business debt. The jury determined that $55,000 advanced to a corporation by taxpayer's partnership was a loan made in the course of the partnership's business. The Government had contended the advance was an investment. The jury also determined the year of worthlessness. [Few facts are reported. *Ed.*] *Mohr,* DC Va., 9/24/56.

Debt-to-equity ratio of 4 to 1 not disproportionate. Taxpayer advanced funds to his corporation for the purpose of altering and renovating a theater building. After the work was completed, the corporation attempted to refinance the property by a loan so as to pay back the advances. It was unable to do this, but later repaid part of taxpayer's advances from its own funds. The court, noting that the debt-to-equity ratio was only 4 to 1, ruled that taxpayer received a repayment of a portion of a bona fide loan rather than a taxable dividend. *Erickson,* TCM 1956-256.

Withdrawal by stockholder a dividend, not a loan. A majority stockholder whose net worth was well in excess of $1 million withdrew $20,000 from the corporation with the consent of the remaining stockholders. The sum was charged to an account "Due from Stockholders." No note or other evidence of indebtedness was executed, no interest was ever paid, and no repayment was made. The court holds the payment was not a loan but a distribution of profits taxable as a dividend. *Niederkrome,* TCM 1956-255.

Stock redemption a dividend to remaining shareholders; it was used to retire their debt. Five individuals (taxpayers here) purchased 400 shares of the stock of a bus company for $400,000. The balance of 350 shares outstanding was taken in the name of the uncle of one of them and was purchased with $350,000 borrowed by one of the five and secured by all of the outstanding stock. The company later disbursed $350,000 in retirement of the uncle's 350 shares and he in turn paid off the bank indebtedness. The court holds the retirement of the stock was a dividend to the remaining five stockholders since the debt cancellation was intended to increase their proportional interests in the remaining assets and future earnings without any additional investment on their part. It paid off the bank loan on which each was liable to the extent of his stock. *Niederkrome,* TCM 1956-255.

Cannot step up basis of inventory on tax-free incorporation. A transfer of partnership assets to taxpayer-corporation is held to be a tax-free exchange. The Commissioner argued that a drawing account received by one of the partners was consideration for the exchange and therefore not "solely for stock." The court finds that it was for compensation for services rendered the corporation. Since the exchange was tax-free, the basis of the inventory to the corporation was the same as it was in the hands of the partners. *Kenney Lumber Co.,* TCM 1956-265.

Stock rights and warrant rights issued together are tax-free. A distribution by a corporation to the holders of its common stock of "package rights" to acquire for each three shares of such stock held, and for a single price, one share of common and one stock purchase warrant will not be income to the stockholders, nor will the issuer have gain or loss. As the Code requires, if the value of the "package right" is less than 15% of the value of the old stock, the shareholder may either use zero as the basis of the right or allocate part of the basis of the old stock in proportion to the value of each at distribution; if the value is over 15%, allocation must certainly be made. *Rev. Rul.* 56-572.

Basis of assets in 77-B reorganization is total of stockholders' and creditors' interest. Taxpayer was revived to take over the assets and continue the business of an insolvent Delaware corporation. Pursuant to a 77-B reorganization, it acquired the assets in a nontaxable exchange. The basis of the assets to taxpayer was held to be the aggregate basis of the stockholders and creditors of the insolvent corporation of their stock and securities in the latter company. The Commissioner argued that prior to the nontaxable exchanges there had been a taxable liquidation which made the basis of the assets to the taxpayer's transferors (the recipients of the distribution in question) fair market value. *Bessemer Limestone and Cement Co.* TCM 1956-250.

Deductions reallocated among controlled corporations. The Commissioner's reallocation of deductions among taxpayer and his four wholly-owned or controlled corporations is sustained. Taxpayer failed to offer in evidence the books and records of the corporations to

prove that the corporations actually incurred the expenses attributed to them. *Peacock,* TCM 1956-245.

Can't amortize, as discount, excess of bonds over basis of property received tax-free. [*Certiorari denied*] In a nontaxable reorganization, taxpayer issued to a gas company bonds having a face value of about $10 million in exchange for properties that had an adjusted basis of about $7 million. Taxpayer contended that as it is required in a nontaxable exchange to use as its basis the adjusted basis in the hands of the transferor, it is entitled to amortize the difference between its total liability on the bonds and the adjusted basis of the property it received as bond discount. The Third Circuit held that failure to establish the fair market value of the property at the time of the transfer precludes the right to the deduction. As to taxpayer's contention that this decision would result in the holder of the bonds paying a tax on the $3 million when it realizes the face amount of the bonds while the taxpayer could never recover more than the basis of the property through depreciation or a subsequent sale, the circuit court said: "It is well settled that a taxpayer is free to adopt such organization for his affairs as he may choose but having done so, he must accept the tax consequence of his choice; this is so whether he contemplates such consequence or not." Furthermore, the court points out that the history of the Treasury Regulations permitting the bond discount amortization indicates that it is applicable to bonds issued for cash, not to bonds issued for property. Moreover, the Regulations would not apply here; this was not an arm's-length transaction; the same parent owned both corporations. *Montana Power Co., cert. den.,* 10/8/56.

Reasonable rental to related taxpayer determined. Taxpayer, a closely held corporation rented auto equipment from a partnership composed of its stockholders. The court finds as a fact that $40,000 was a reasonable rental, and it disallowed a deduction for the excess. *Drilling and Service, Inc.,* TCM 1956-272.

Loss on exchange of property for own stock deductible. Taxpayer-corporation, an auto agency, transferred to one of its stockholders a building in exchange for $50,000 in cash plus its own stock valued at $125,000. The court holds the transfer of the building was not in partial liquidation because there was no contraction of the business. It was a sale of property having a cost basis of $182,500 for cash and shares of stock having a value of $175,000. The corporation therefore sustained a deductible loss of $7,500. *Johnson-McReynolds Chevrolet Corp.,* 27 TC No. 31.

Salaries to directors unreasonable. To each of its part-time stockholder-directors, taxpayer paid $9,000 "for services rendered," but the Commissioner's allowance of $2,000 is approved by the court. The $9,000 figure, it says, was an arbitrary figure paid without respect to the services rendered. *Wilshire-La Cienega Gardens Co.,* DC Calif., 8/13/56.

Compensation supported by past services held reasonable. A president of a jewelry business, who had been receiving a salary of $30,000 a year, suffered an incapacitating illness in 1949. His salary was not reduced in 1950 or 1951. In 1952, he received $24,000. The Tax Court held that $10,000 was a reasonable salary for each of the years 1950-1952 in consideration for past services whose value was in excess of salary received. This court affirms. *Perel & Lowenstein, Inc.* CA-6, 10/23/56.

Auto agency bonus of 15% of profit to stockholder-manager upheld. In 1949 and 1950, the general manager and principal stockholder received a base salary of $12,000. In 1949, he received a bonus of 15% of corporate profits before taxes. In 1950, the bonus was 20%. The court holds the bonus was warranted because of the increased business and profits, the extent and scope of taxpayer's work, his diligence and qualifications, his salary in previous years and his stock interest. *Waits Motors, Inc.,* DC SC, 10/29/56.

For consolidated return, common parent must be in affiliated group. Two includible corporations, one owning all the stock of the other, and both being members of an affiliated group of which a third corporation is the common parent, do not constitute a separate affiliated group privileged to file consolidated income tax returns. *Rev. Rul.* 56-559.

Oil-royalty expenses over 15% gross income; not a PHC. The Code includes mineral oil and gas royalties as personal holding company income unless they are 50% of the gross income, and unless deductions (other than compensation to shareholders) are equal to 15% or more of gross income. The corporation paid compensation of over 15% to an individual who, though he was a stockholder of record, was not, the Court finds, the beneficial owner. *Southern Trading Co.,* TCM 1956-246.

Affiliate's loss carryover reduced by its adjustments only. In determining a net operating loss deduction in a consolidated return for 1953 arising from a net operating loss carryover of an affiliate from years for which separate returns were filed, the carryover is to be reduced by 1939 Code Section 122(d) adjustments for the year of deduction applicable only to the loss affiliate. *Rev. Rul.* 56-623.

Capital gain on redemption of stock of son of major stockholder. A son acquired a 7% stock interest in his employer-corporation by gift from his father who was a major stockholder and president of the firm. Five years later the son left the employ of the corporation and has since engaged in an unrelated business. A complete redemption of the son's stock at his request is held to qualify for capital gains treatment under Section 302, provided he does not reacquire an interest within ten years. The son's acquisition by gift within ten years of the redemption was for a good business purpose: to interest him in the firm. The ten-year condition being met, the family-attribution rules do not apply, and the redemption being a complete termination of the son's interest, the gain is deemed to be capital. *Rev. Rul.* 56-584.

New preferred in recapitalization is "306 stock." For valid business reasons, the majority stockholders — all members of one family — exchanged their preferred shares plus accrued dividend arrearages for new subordinated preferred. The preferred held by outsiders (7%) was redeemed for cash. The Service rules that the transaction was a tax-free recapitalization, but that the new preferred is "306 stock" in the amount that would have been a taxable dividend if cash had been distributed. The cash redemption of the minority holders' preferred gives capital gain or loss. *Rev. Rul.* 56-586.

TAXATION OF

Partnerships

EDITED BY JACKSON L. BOUGHNER, LL.B., CPA

How to obtain best tax treatment for payments for a partner's interest

NOW THAT THE final Regulations are available, practitioners have the opportunity to arrange their own and their clients' partnership affairs so that payments for the interest of a deceased or retiring partner can be either capital (nondeductible), or income (deductible). No matter which method they choose, they will succeed in saving taxes only if the partnership agreement is in the proper form and if the Code provisions on partnership and cross-purchase insurance are properly weighed. Only in that light can a proper, tax-saving, choice be made. Such light was brought to this subject recently by Arthur B. Willis, of Los Angeles, who is one of the country's best-informed lawyers on taxation of partnerships (he is chairman of the committee on partnerships of the Section on Taxation of the American Bar Association) and Robert Farmer. In speaking at a tax forum sponsored by the Title Insurance and Trust Co. of Los Angeles, they made these observations:*

The significance of the partnership agreement is greatly magnified by the 1954 Code. Not only does the agreement continue to control the legal and economic relations among the partners, but it also takes on new responsibility in establishing the pattern for many important tax matters. This is well illustrated in connection with the drafting of provisions on the partnership agreement to cover the possibility of death or withdrawal of a partner.

One of the difficult problems in drafting the buy-and-sell provisions of a partnership agreement is working out the determination of the proper amount to pay a retiring partner or the estate of a deceased partner for his interest in the partnership. It is not possible to cover the valuation problem in this paper.[1]

There is also the problem of determining what payment should be made for the interest of a retiring or deceased partner in the partnership's intangibles such as goodwill. Even though the partners may agree that there is no goodwill in the usual sense, they may still desire, as a matter of mutual insurance, to provide that certain payments, in excess of the value of a partner's interest in the assets of the partnership, should be made to a withdrawing partner or to the estate of a deceased partner.

Section 736 of the 1954 Code is intended to eliminate the doubts and confusions that previously existed about whether such payments were distributions of ordinary income to the retiring or deceased partner or were payments for his capital interest in the partnership. The specific rules laid down in Section 736 make it possible to provide in the partnership agreement for payments to a deceased or retiring partner that will clearly constitute an income transaction or a capital transaction, whichever is desired.

The first tier of payment—for assets

Assume that the value of the partnership properties, exclusive of goodwill, of the A-B-C partnership is $90,000. Payments for this interest in the partnership are required to be treated as a capital transaction with respect to the continuing partners and also with respect to the retiring or deceased partner. This is true regardless of the way payments are made. Thus, if the only payments made to a retiring or deceased partner are based on a percentage of partnership income following his retirement or death, nevertheless those payments applicable to his capital interest, exclusive of goodwill, must be treated as payment for his capital interest in the partnership rather than as a distribution of partnership income. There is no option available to the partners. The only freedom of movement lies in the valuation of the interest in partnership property, exclusive of goodwill. The Regulations provide[2] that "generally the valuation placed by the partners upon a partner's interest in partnership property in an arm's length agreement will be regarded as correct." Even here there are definite limits of good faith and reasonableness on the valuation that may be placed upon the interest in the partnership property.

Second tier—for goodwill

The second tier of payments includes within its range payments to a retiring or deceased partner for his interest in partnership goodwill. Payments falling within this second tier may constitute either a capital transaction or an income transaction, depending upon the provisions of the partnership agreement.

If it is desired that payments for a partner's interest in goodwill shall constitute a capital transaction, the partnership agreement must specifically provide for a payment to be made to a retiring partner, or to the successor in interest of a deceased partner, for his interest in the partnership goodwill.[3] The Regulations require that the value attributed to goodwill must be reasonable.[4]

The partners may decide that a better income tax result would be obtained if the additional payments were taxed as ordinary income to the recipient and thus reduce the taxable income of the continuing partners. This result can be achieved through eliminating any reference in the partnership agreement to a payment for goodwill. If this is done, the payments to the retiring or deceased partner, even though actually for his interest in the partnership goodwill, constitute a distribution of income to the retiring or deceased partner and, to that extent, reduce the taxable income of the continuing partners. To achieve income treatment of payments in this tier, they must be made by the partnership. Payments made by the other partners, as distinguished from the partnership, cannot qualify for treatment as distributions of partnership income.[5]

There is no clear indication as to the extent to which the Service may go in

*The complete text of this paper will be published in a future issue of *Trusts and Estates* magazine.

[1] For a discussion of the problems of valuation of partnership interests, see Forster and Willis, *How to Draft a Partnership Buy and Sell Agreement*, 1956 So. Calif. Tax Inst. 57, at 59.

[2] Regs. Sec. 1.736-1(b)(1).

[3] Int. Rev. Code (1954) Sec. 736(b)(2)(B).

[4] Regs. Sec. 1.736-1(b)(3). This is based upon a reference to a reasonable valuation of goodwill found in the Senate Finance Committee Report on the Internal Revenue Code of 1954 (Sen. Rep. No. 1622, 83d Cong., 2d Sess. 395).

[5] Regs. Sec. 1.736-1(a)(1)(i).

distinguishing between goodwill and items such as patents, copyrights, formulas and similar intangibles, many of which tend to blend in almost imperceptibly with goodwill. The only safe course, if a capital transaction is desired, is to have the partnership agreement specifically designate the payment as being made for the retiring or deceased partner's interest in the goodwill of the partnership.

Third tier—the remainder

The third tier includes payments by the partnership other than those made for the retiring or deceased partner's interest in partnership properties, including a reasonable valuation for goodwill. This is the top level of payments—those made in excess of the payment for the interest in partnership property, including a reasonable valuation for goodwill. Any payment in the third tier must be treated as ordinary income to the recipient and consequently will reduce to that extent the taxable income of the continuing partners.

The Proposed Regulations[6] restricted the application of Section 736(a) (the third tier) to cases where the payment by a partnership was made in cash and in two or more taxable years of the partnership. The Regulations as promulgated in final form significantly eliminate this requirement. This means that any payment to a retiring or deceased partner in excess of the fair valuation of his interest in the partnership property, including a reasonable valuation for goodwill, will be taxed as ordinary income to the recipient even though the payment is made in a lump sum and is made in the form of property other than money. It is likely that this will produce some strange and unexpected results.

USING TIERS FOR PAYMENTS TO A DECEASED PARTNER

In discussing the provision for payments to a deceased partner, the members of the A-B-C partnership agree that the successor in interest of a deceased partner shall receive $50,000, payable at the rate of $10,000 a year for five years, in excess of the amount paid for his interest in the partnership property, exclusive of goodwill. The problem is whether to make such payments a capital transaction or a distribution of ordinary income.

First, suppose the transaction is framed as a capital transaction. This requires that the partnership agreement specifically provide that the valuation of a deceased partner's interest in goodwill is $50,000 and that payments for his interest shall be at the rate of $10,000 a year for five years. It is assumed for the present purposes that the valuation is a reasonable one. The successor in interest of the deceased partner will pay no income tax on the receipt of the $10,000 a year, since this will merely be a part of the purchase price of the partnership interest. The adjusted basis for the interest of the deceased partner in the partnership will reflect the fair market value of that interest at the date of the partner's death.[7] The $50,000 payment for the deceased partner's interest in goodwill will be reflected in that value and hence in the basis of the partnership interest.

However, the surviving partners will be required to report in their taxable income their distributive shares (we assume it is one-half to each) of the partnership income, without reduction for the payment of $10,000 a year to the estate of the deceased partner. Thus, if the partnership income were $60,000 following the death of a partner, the two surviving partners must each pay tax on $30,000 of income even though each only had $25,000 left after paying his $5,000 share of the $10,000 payment to the estate of the deceased partner. The tax of the two surviving partners, assuming that they are married and have other income exactly equal to the total of their deductions and exemptions, would be approximately $9,500 each. The total tax on the two partners would be $19,900.

After deducting both taxes and payments to the estate of the deceased partner, each of the two surviving partners would have $15,500 left. The estate of the deceased partner would have the full $10,000 since there is no income tax to pay on that amount. Thus, the total net remaining after tax for the two surviving partners and the estate of the deceased partner would be $41,000.

Payments to be income

The alternative would be to make the payments an income distribution. This is accomplished by eliminating any reference in the partnership agreement to a payment for the interest of a deceased partner in partnership goodwill, and having the payments made by the partnership. Here the $10,000 a year paid to the estate of a deceased partner would be ordinary income to the estate and would reduce by $10,000 the surviving partners' taxable income from the partnership.

The two surviving partners would each report taxable income from the partnership of $25,000 (one-half of $60,000 minus the $5,000 share of each partner in the payment to the deceased partner's estate). Each of the two surviving partners would pay a tax of approximately $7,200 on his $25,000 share of partnership income. The estate of the deceased partner and his surviving spouse would pay a tax of approximately $2,200 on $10,000 of ordinary income. The total income tax payable by the two surviving partners and by the estate of the deceased partner would be $16,600. This is $2,400 per year less than the total tax payable if the payment were made to the deceased partner for his interest in the partnership goodwill.

Actually, the mathematics of the above case do not go far enough. All of the tax-saving resulting from making the $10,000 payment to the estate of a deceased partner an income transaction rather than a capital transaction is for the benefit of the surviving partners. The estate of the deceased partner is required to pay income tax on the $10,000 annual payment and is economically harmed to the extent of that tax. Perhaps the partners should consider increasing the payment to the estate of a deceased partner, but making it an income distribution and hence a reduction of their taxable income. A projection of the figures used here discloses that it would be possible to pay as much as $16,000 a year to the estate of a deceased partner and still leave the surviving partners with more net income after tax than if they paid $10,000 a year to the estate of the deceased partner for his interest in partnership goodwill. The estate of the deceased partner would also be better off since, even after income tax, it would have left approximately $12,100. This is $2,100 more than would be realized if payments of $10,000 a year were made for the deceased partner's interest in the partnership goodwill.

Cross-purchase insurance

In prior years the general tendency has been to use the cross-purchase arrangement where the buy-and-sell pro-

[6] Prop. Regs. Sec. 1.736-1(a)(2).
[7] Int. Rev. Code (1954) Sec. 1014(a).
[8] For a discussion of the former reasons for use of the cross-purchase arrangement rather than the entity approach, see Forster and Willis, *How to Draft a Partnership Buy and Sell Agreement*, 1956 So. Calif. Tax Inst. 57, at 73.

visions of the partnership agreement are funded with life insurance.[8] Under the cross-purchase arrangement, each partner buys insurance on the lives of the other partners. Thus in the A-B-C partnership, A would own, pay premiums on, and be the beneficiary of policies on the lives of B and C. B would do likewise with A and C, and C would do the same with A and B. Due to several changes in the 1954 Code, most of the tax reasons that previously existed in favor of the cross-purchase arrangement have been eliminated.[9]

Under the entity approach, the partnership itself applies for, owns, is the beneficiary of, and pays the premiums on policies on the partners' lives. With the elimination of the tax objections, some real and some imaginary, that previously existed to use of the cross-purchase arrangement, it may be said as a general matter that the scheme of partnership taxation provisions of the 1954 Code tends to favor partnership ownership of insurance rather than the cross-purchase arrangement. A most important reason is that a cross-purchase arrangement may force a termination of the partnership.

For example, Section 708(b)(1)(B) provides if within a 12-month period there is a sale of 50% of the total interest in partnership capital and profits, then the partnership is deemed terminated. The Regulations make it clear[10] that a sale to other members of the partnership will terminate the partnership if the interest transferred constitutes more than a 50% interest in partnership capital and profits (or will total more than a 50% interest when combined with other sales of partnership interest made within a 12-month period). Therefore, if the interest of a prospective deceased partner in partnership capital and profits is more than 50%, or if the retirement of his interest combined with another change in partnership interest would result in a change of more than a 50% interest in partnership capital and profits, the partnership will be terminated under the cross-purchase arrangement.

Termination of the partnership may or may not be serious, depending on various circumstances. If the partnership has a taxable year different from the taxable year of the partners, it is possible that termination of the partnership will result in a bunching of partnership income in the returns of the partners. This would be true, for example, if the partnership were reporting on a June 30 taxable year, and all of the partners were on a calendar year basis, and if the partnership were terminated at any time between July 1 and December 31.

There may be other significant tax consequences of the termination of the partnership. The Regulations provide[12] that upon termination the partnership is deemed to distribute its properties to the transferee of the interest and the other remaining partners, and that immediately thereafter they are deemed to have contributed such properties to a new partnership. This may affect the allocation of gain or loss with respect to contributed properties under Section 704(c). If the partnership has installment-obligation contracts, income from which is being reported under Section 453, the termination of the partnership and the consequent constructive distribution of property may be such a disposition of the installment-obligation contracts as to require the terminated partnership to report in its final return, pursuant to Section 453(d), all of the deferred income on the installment-obligation contracts.

Continuing the partnership

If it is desired not to terminate the partnership, the Regulations suggest a solution where the interest of the deceased partner is to be acquired by the other partners. The Regulations provide[11] that the disposition of a partnership interest by liquidation is not such a sale or exchange as will terminate the partnership because of a transfer of an interest of more than 50% in partnership capital and profits. Consequently, if the partnership owns the insurance on the lives of the partners and receives the proceeds of the policy upon death of a partner, the partnership can retire the interest of the deceased partner by distributions in liquidation without danger of terminating the partnership.

There is another reason for having the partnership own the insurance. If it is desired that the deceased partner's estate receive payments that constitute distributions of partnership income, the payments must be made by the partnership.[13] Payments made by the surviving partners, such as those that would usually be made under a cross-purchase arrangement, cannot qualify as distributions of partnership income under Section 736(a).

Of course it would still be possible to have a cross-purchase arrangement and use the income-distribution privilege. However, this would require that the partners who had received the insurance proceeds on the life of the deceased partner contribute such proceeds to their capital accounts and then have the partnership make distributions in liquidation of the deceased partner's interest. There is a slight danger that this might be challenged under the step-transaction rule as being really a payment by the surviving partners. The danger of the step-transaction theory being applied to this situation is believed to be relatively small, but it is a factor to consider in deciding whether the cross-purchase arrangement should be used or whether the partnership should pay for the insurance.

Death of one of two partners

Section 708(b)(1)(A) provides that the partnership shall be terminated if no part of the business continues to be carried on by any of its partners "in a partnership." This raises a serious problem in the case of a two-man partnership. If one partner dies or withdraws and his interest is acquired by the other partner, obviously the one remaining owner would no longer be conducting business as a partnership. Technically, the partnership should be terminated by death or withdrawal of one partner. The termination affects the surviving partner as well as the deceased partner.

In drawing the partnership agreement for the two-man partnership, it is well to keep this problem in mind. There is a solution. The Regulations state[14] that a retiring partner or the successor in interest of a deceased partner who receives

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[8] Id.
[9] Regs. Sec. 1.708-1(b)(1)(ii).
[10] Regs. Sec. 1.708-1(b)(1)(ii).
[11] Regs. Sec. 1.708-1(b)(1)(iv).
[12] Regs. Sec. 1.736-1(a)(1)(i). See discussion of this point supra.
[13] Regs. Sec. 1.736-1(a)(6).

payments that qualify under Section 736 is regarded as a partner until the entire interest of the retiring or deceased partner is liquidated. Therefore, if one of the members of a two-man partnership retires or dies and if the partnership agreement provides that he is to receive payments for his interest, the partnership will not be considered terminated nor will the partnership year close with respect to either partner until the retiring partner's entire interest is liquidated. The theory of the Regulations is that the retiring partner continues to hold a partnership interest in the partnership until final liquidation of that interest.

This is solely an income tax concept and does not conform with state-law principles of partnership. For example, the partnership agreement for a two-man partnership might provide for immediate retirement of a partner's interest in the partnership property, other than goodwill, and for additional payments to be made over a period of years, either for the interest of the retiring or the deceased partner in partnership goodwill or as a form of mutual insurance. So long as such payments are made, the partnership is deemed to continue for income tax purposes even though the capital interest of the retiring or deceased partner has been fully retired.

The Regulations do not specify how substantial the payments under Section 736 must be in order to keep the partnership in existence for income tax purposes. Theoretically it might be possible to pay the retiring partner or the deceased one dollar a year for 25 years, and such payments would result in the partnership continuing. It is suggested, however, that a practical approach be adopted and that the payments be sufficiently large so that there will be no danger that the Commissioner or the courts would disregard them under the theory *de minimis*. ☆

Partnership income shows slowest rate of increase

PARTNERSHIPS SHOWED smaller increases in total receipts and total number of businesses than either corporations or individual proprietorships in 1953, according to figures just released by Commissioner Harrington. While corporate receipts jumped 52% from 367 billion in 1947 to $557 billion, and sole-proprietorship receipts increased 42% to $144 billion, partnership receipts increased only 33%, moving from $61 billion to $81 billion.

Figures for total number of businesses showed a similar pattern. The number of corporations increased 26% to 698,000, sole proprietorships increased 16% to 7,714,000, and partnerships lagged behind with an 8% rise, increasing to only 958,000.

These partnerships, formed by 2,300,000 partners, did however earn a record $9 billion of profits. Never before had partnership income been so high. Receipts for the 840,000 partnerships which had profits amounted to $75 billion. About 115,000 partnerships showed no net profits.

The partnership form was used most widely in the retail and wholesale trade. Thirty-seven per cent of all partnerships were in this group. Services, such as accounting and law firms, had the next highest total, and the farming, real-estate and construction industries totals were not far behind.

Physician, surgeon, and oculist partnerships averaged the highest net income, approximately $20,000 per partner. Engineering and architectural service partners averaged almost $13,000, attorneys $11,600, dentists $10,000, and accountants $8,800. ☆

New partnership decisions this month

Wife investing gift capital not recognized as partner. With capital given her by her husband, a wife invested in two partnerships operating taxis. Although she performed relatively inconsequential services, she received substantial distributions of profits, most of which was invested in projects which interested her husband. The court concludes that the parties at no time intended that the wife be a bona fide partner. *Niederkrome*, TCM 1956-255.

No intent that wife act as partner. In consideration of the receipt of a loan from his father-in-law, taxpayer agreed to share equally with his wife any profits (but not losses) from an investment of the funds. The court refuses to recognize the wife as a partner in the investment. No money was contributed by her, no accounting was made to her, and her acquiescence in the arrangement between her husband and father was considered essentially a personal family affair. *Williams*, TCM 1956-270.

Partnership income can be allocated by annual agreement of partners. Taxpayer's partnership agreement provided that the partners would divide the profits each year on a mutually agreeable basis, which is in fact what they did. The Commissioner reallocated the income on the basis of ownership. The court holds the Commissioner erred. *Minkoff*, TCM 1956-269.

Partner's gross income includes his share of firm gross. Section 251 of the 1939 Code permits U. S. citizens to exclude income from sources within U. S. possessions if certain conditions are met. One of these conditions is that 80% of the gross income for three years prior to the taxable year must have been derived within a U. S. possession. In determining whether taxpayer, a member of a partnership, met this 80% test, the court holds he must include in his personal gross income his distributive share of the partnership's "gross" rather than the "net" income. Although the language of the Code literally required the partner to include his share of the partnership net, the cases have considered that each partner owns a share interest in the partnership gross because the partnership is not a tax-paying entity. Only in the case of the 25% income omission for statute of limitations is the partnership net regarded as the partner's gross. *Palda*, 27 TC No. 49.

Partnership of wives invalid; husbands were in control. Taxpayers transferred their stock in a construction company to their wives. The wives liquidated the assets and formed an alleged partnership for the purpose of renting the construction equipment and selling gravel to a new partnership formed by their husbands. The court finds that taxpayers exercised complete control over the assets which had been owned by the corporation and had been ostensibly distributed to the wives. Since the husbands never intended to give away the ownership and control over the assets, the partnership of wives is not valid for tax purposes. Similarly, alleged gifts by the wives to their children of some 19

trucks received on liquidation of the corporation are held to be without substance where taxpayers maintained unrestricted control over their use. *Finley*, 27 TC No. 46.

Payment to retiring partner can be amortized over remaining partnership life. [*Acquiescence*] Taxpayer and another were in partnership for the operation of an employment agency. After a dispute arose between the two, taxpayer paid his partner $8,500 to buy out her interest at a time when the partnership agreement had 20 months to run. The court held that this payment was a capital expenditure which could be amortized over the remaining 20-month period. This was not a case of buying out a partner under an agreement of indefinite duration, the court points out. Here, where the partners' rights would end in 20 months, the situation is like a landlord buying a tenant's unexpired lease. *Risko*, 26 TC No. 58, *acq.* IRB 1956-47.

Partnership with secretary valid for tax purposes. A parking lot operated by taxpayer and his secretary as a partnership is held to be valid for tax purposes. The partnership agreements always provided for a sharing of profits and losses; the secretary was unrelated; she continuously attended to the detail audit and bookkeeping work for the partnership; she was in a position to oversee the operation of the lot; and no strings were attached to her withdrawal of the credit balance in her partnership account. *Peacock*, TCM 1956-245.

Partner taxable on board and lodging though for convenience of partnership. Taxpayer, manager and part owner of a hotel, was required to live in the hotel. He, his wife, and his daughter received their board and lodging at no cost. The district court held that their value was not taxable. This court reverses. It agrees with the Fourth Circuit (*Doak*, 234 F2d 704) and the Eighth (*Moran*, 5/10/56) that the convenience-of-the-employer test is not applicable to partners. They are not employees. *Briggs*, CA-10, 10/23/56.

Miscellaneous new decisions this month

Stockholders, operating corporate mine, can take depletion. The Service holds that in the typical operation of a captive coal mine the stockholders of the mine company possess by virtue of their contract with the mining company an economic interest in the coal in place and may deduct depletion. In these operations, one or more manufacturers, owning all the stock in the mining company, contract to provide all cash needed in return for its entire output. *Rev. Rul.* 56-542.

Percentage depletion allowed on value of brick. This is another case which holds the Commissioner errs in denying percentage depletion on the value of brick as the first commercially marketable mineral product from clay. *Tupeto Brick and Tile Co.*, DC Miss., 10/5/56.

Clay depletion figured on value of brick. In another of the cases involving determination of the first commercially marketable product of clay (the point at which percentage depletion is computed), the court holds clay is not commercially marketable. Depletion is therefore based on the gross income from the sale of the commercially marketable brick and tile. *Atlanta Brick and Tile Co.*, DC Ga., 10/30/56. Similarly *Acme Brick Co.*, DC Tex., 10/9/56; *Elgin-Butler Clay Brick Co.*, DC Tex., 11/14/56.

Stock dividend prior to March 1, 1913 not included in equity invested capital. The Tax Court held that dividends paid prior to March 1, 1913 of common on common are not includible in equity invested capital in determining excess profits tax liability for the period 1940-1945. By the payment of the pre-1913 stock dividends, taxpayer created a deficit in surplus. It wished to include the dividends as capital and omit the deficit as the Code permitted. This court reverses, following its own *Owensboro Wagon* case (209 F2d 617). *Richmond Hosiery Mills*, CA-6, 11/2/56. Similarly, *Stacy Mfg. Co.*, CA-6, 11/2/56.

Sec. 722 relief denied button manufacturer. A corporation manufacturing and selling plastic buttons changed its capacity for production or operation during the base period. It is denied a constructive-average base-period net income in excess of that computed by the Commissioner. *Patent Button Co. of Tenn.*, 27 TC No .52.

Moneys advanced by customer not invested capital. Taxpayer contracted to manufacture airplane engines for Great Britain in 1940 and 1941. The British Government advanced $20 million for the purchase of machinery and tools which would at all times belong to it. The Government further advanced $19 million in a revolving fund to help taxpayer meet the costs of manufacture. Taxpayer was guaranteed a minimum profit of $1.2 million on the initial contract. The court allows the advance of $19 million less the $1.2 guarantee as borrowed invested capital under the special provision allowing certain advances by foreign governments to be treated as borrowings. The $20 million is not allowed as invested capital because it was not taxpayer's investment. *Studebaker-Packard Corp.*, Ct. Cl., 11/7/56.

Intercompany notes payable by subsidiary qualify as borrowed capital. Subsidiary corporations which compute their separate excess profits credit under the income method may include notes payable to the parent in the computation of net capital additions if the notes represent good-faith advances from the parent on open account, which were used by the subsidiaries for business purposes. *Rev. Rul.* 56-523.

GM warranty refunds: interest runs from allowance date. This case involves a General Motors claim for a refund of excise taxes on refrigerators on account of payments it made to customers because of its warranty on sales made in 1942-1944. In another case (128 Ct. Cl. 465, *cert. den.* 348 U.S. 942) involving prior years, this court held that such payments were an "allowance or discount" and taxpayer was entitled to a refund of excise tax paid at the time of sale. The court merely follows its previous holding; however, it explains in detail why interest is allowable from the date the taxpayer makes refund to the customer. Though the law prohibits interest on refund of tax because of allowances made by the taxpayer, the statute applies to refunds made administratively, not to those litigated. *General Motors Corp.*, Ct. Cl., 11/7/56.

NEW DEVELOPMENTS IN TAX ASPECTS OF

Accounting

EDITED BY CARL M. ESENOFF, CPA, & C. W. LAMDEN, Ph.D., CPA

How to handle vacation-pay accruals pending Treasury's action on rules

by WILLIAM J. SCHWANBECK

Against a background of Treasury indecision, taxpayers and their tax advisers remain in a quandary about vacation-pay accruals. The Treasury set forth a new policy in Rev. Rul. 54-608, but it later postponed the effective date. This on-again, off-again policy has made taxpayers uncertain of their present policies but hesitant to adopt new ones. But some steps can be taken to make sure that the firm is on the right path. This article not only gives practical advice on the steps to be taken pending further Treasury decision, but it also comprehensively reviews the problem.

BEFORE 1947, the tax deduction for vacation wages received little attention. Only as employers granted more liberal vacation rights did accountants become concerned about recording the liability of accrued-vacation pay, and timing its tax deduction. Cash-basis taxpayers, of course, had no problem; their right to the deduction in the year of payment is and has been fundamental. But accrual-basis taxpayers have run into one problem after another. Although many employers began by deducting vacation wages in the year paid, they have, for one reason or another, changed the vacation-wage deduction from a cash to accrual basis. These changes led to several Treasury rulings and court decisions.

The first of these came in 1947. The Treasury issued a ruling which allowed the deduction for accrued vacations if the amount was payable pursuant to a union contract in existence at the taxable year end. The ruling denied a deduction for increased benefits provided in a contract executed after the close of the year.

A special ruling in a Commissioner's letter in 1948 and another ruling in 1949 extended the principle. They permitted a deduction for vacation for employees who qualified by the year end, even though some of them terminated their employment before the vacation period and forfeited their vacations. As a result, vacation pay was accruable if most of the employees were eligible at the year end; the subsequent forfeitures merely affected the amount of the accrual.

I.T. 3956 (1949) also answered a frequently asked question. That was: is the employer required to change his accounting system from a cash basis and to begin accruing vacation pay if his employment contract creates an accruable liability under these rules? The ruling said that if a substantial condition to the actual payment exists then the employer who consistently deducts vacation pay when paid can continue to do so. For example, if the employee must be in the employ at the time he is to take his scheduled vacation, such a condition exists.

After these rulings were issued, many employers, re-examining their employment contracts, found that they were qualified to use the accrual basis. Some who were qualified switched; others did not. And some of those who were not qualified amended their contracts to qualify.

Litigation on vacation pay accruals

The accrued-vacation issue first came before the courts in one case in 1950[1] and two cases in 1952.[2] In each case the court denied the accrual, fundamentally because circumstances in each case did not create all of the elements necessary to bring about liability at the taxable year end. The *Sheldon* case is the most significant. The Tax Court held that the liability was contingent at the taxable year end because an employee would be disqualified if he left before the vacation period. It has always been a fundamental tax principle that only an unconditional liability can be accrued. The Treasury rulings discussed above recognized the liability owing to the eligible employees as a group. Individual forefeitures merely affected the amount of the liability. However, the courts have stated that the liability to an individual employee must be unconditional; the vacation wage does not accrue for tax purposes unless all of the conditions precedent with respect to a *particular* employee have occurred and his vacation rights have been unconditionally vested at the accrual date.

54-608 not yet in effect

Following the court decisions, *Rev. Rul.* 54-608 was issued, but it has not yet been put into effect. On July 2, 1956, *Rev. Rul.* 56-315 deferred for the second time the applicability of *Rev. Rul.* 54-608 so that it would not apply to taxable years ending before January 1, 1957. When *Rev. Rul.* 54-608 becomes effective, the vacation-wage accrual will be governed by the following rules:

1. The accrual on December 31 for a calendar-year company is limited to the liability to a specific person clearly established on December 31 if the amount of the liability to each individual is capable of computation at that time with reasonable accuracy.

2. Liability under an unwritten policy may be accrued if the plan or policy is communicated to the employee prior to the beginning of the next vacation year and the employee's vacation rights are vested on or before December 31.

3. Additional vacation benefits provided in contracts executed after Decem-

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[1] Tennessee Consolidated Coal Co., 15 TC 424 (1950).
[2] Morrisdale Coal Mining Co., 19 TC 208 (1952) and E. H. Sheldon & Co., 19 TC 481 (1952), *aff'd.*, 214 Fed. 2d 655 (1954).

ber 31 are not accruable at that date.

Rev. Rul. 54-608 was issued shortly after Congress amended the tax law so that reserves for estimated expenses (the much-publicized Section 462) could be deducted. Although many vacation-wage provisions did not qualify for a deduction under *Rev. Rul.* 54-608, there was no great concern at the time it was issued since those employers who had deducted vacations on the basis of prior rulings were permitted to continue to deduct vacations as a reserve. But when Section 462 was repealed in June 1955, the vacation deduction became subject to the rules of *Rev. Rul.* 54-608.

Whether and when a liability is created is usually a mixed question of law and fact. It is too early to know how rigidly *Rev. Rul.* 54-608 will be enforced by the Commissioner and whether the courts will support him. That questions will arise is certain. If all or part of the vacation is "earned" by December 31, termination of employment before the vacation is taken generally will not free the employer from liability. But a literal interpretation of *Rev. Rul.* 54-608 requires that the liability to a specific person can be clearly established — that is, that under no circumstances can the employee be denied his vacation rights. Yet a layoff or voluntary termination could divest the employee of his vacation rights, and discharge for cause, death or failure to take the vacation during the vacation period can result in forfeiture. These possibilities seem to indicate that the employee's rights are not fully vested.

Many will be denied accrual

Until the courts clearly interpret *Rev. Rul.* 54-608, the threat remains. Under it, vacation wages can be accrued for tax purposes only to the extent that they are earned prior to the end of the taxable year by each employee, separately considered, and to the extent that his rights are vested and cannot be forfeited by termination, whether by quitting, discharge, or death.

A large majority of employers are subject to employment agreements and policies which do not qualify for the vacation-wage deduction under *Rev. Rul.* 54-608. They must decide whether they should amend the agreement to provide vested vacation rights and thus obtain the tax accrual or whether they should allow present employment agreements to continue and give up the accrual.

Prior to the promulgation of *Rev. Rul.* 54-608, some employers found that although they had been deducting vacation wages as paid the employment contract would support an accrual. Yet they were reluctant to change to the accrual basis. They feared that the Treasury Department would hold that contracts in effect in prior years also required an accrual and that the transfer of each year's deduction back to the preceding year would eventually push back a deduction into a closed year. As stated above, I.T. 3956, which has been revoked, permitted a continuance of the cash basis "if there is a substantial condition to actual payment, such as being in the employ of the employer at the time of the scheduled vacation." However, under *Rev. Rul.* 54-608, vacation pay subject to such conditions can be deducted only when paid.

Employers must be informed

The taxpayers who have claimed vacation wages on the accrual basis and have been allowed the deduction under I.T. 3956 are those who would be vitally affected when *Rev. Rul.* 54-608 is put into effect. It is important that these employers be informed that they might be required to amend their employment agreements or face the possible loss of a vacation deduction for the year of change from the accrual to the cash basis.

To make certain that he obtains the right to accrue, the employer must grant to the employees vested vacation rights at the end of the taxable year. If no accrual is allowed, the deduction for vacation wages is not lost forever but is merely postponed; the timing of the tax benefit frequently becomes secondary to the employer's personnel policy with respect to vacations.

If an oral employment agreement or informal vacation policy is presently in effect, the employer can improve his position by converting the agreement or policy to writing and by communicating the written agreement to the employees before the time of accrual. The agreement should include necessary vacation provisions to assure the deduction, and it should state that continued employment to the end of the year is consideration for the employee's rights and benefits. Present written employment agreements or employee work manuals and booklets should be revised and reissued. If possible, contracts should be renewed before the end of the year to incorporate the necessary vacation provisions.

Employers may wish to limit the vesting to that part of the vacation earned to the end of the year. Whether the amount is part or all of the vacation, the amount accruable for tax purposes can be no more than that portion vested at the end of the year. To accomplish a month-by-month accrual, some employers credit the employees with a fraction of their vacation each month and allow the vacation earned, or pay in lieu thereof, at the time of termination. If the vacation earned cannot be forfeited under any circumstances, or if pay in lieu thereof is payable in all events even if the employee dies, the vacation, to the extent vested, is accruable.

Future possibilities

When Section 462 was repealed in June 1955, taxpayers lost their opportunity to deduct vacation wages on a reserve basis and to conform their tax accounting with general accounting. If Section 462 had remained law, most of the vacation-wage tax problems would have been solved. There is yet hope that vacation wages may someday be deductible on a reserve basis. The President in January 1954 recommended to Congress that tax accounting should be brought more nearly in line with accepted business accounting by allowing reserves to be established for known expenses. The Committee on Finance, in its report accompanying the bill repealing Section 462, acknowledged this recommendation and indicated that the principle of Section 462 was not forever abandoned but that a proper substitute would be attempted in the near future. ☆

Expenses allowable in carryover from closed loss year?

IN REV. RUL. 56-285, the Service said that when it determines the carryover in a later year it can reduce the operating loss in an earlier closed year by the amount of the excessive depreciation claimed in that year. Robert Burke, Corpus Christi attorney, writes us that this would imply that the taxpayer is permitted to show that the loss was understated. He writes:

Recently, one of my clients went into bankruptcy. He, of course, had an operating loss; both 1952 and 1953 were loss years. The 1952 return was examined by the Revenue Service and ac-

cepted as filed and a carryback permitted In examining the 1953 income tax return, the Service discovered about $17,000 of accrued expenses that should have been claimed in 1952 but were not. They have proposed to disallow the deduction in 1953 and because the statute of limitations has barred the year 1952, they have proposed not to allow any adjustment to the net operating loss carryforward from 1952. The case is not settled; it has not as yet gone beyond the agent. I believe that he will have to make the adjustment based upon *Rev. Rul.* 56-285.

My basis for this contention is the last paragraph of that ruling, which I quote:

"The fact that the statutory period for assessment of income taxes for the year in which the loss was sustained has expired does not preclude the making of such adjustments as may be necessary to correct the net operating loss deduction."

The significance of this statement should be lost to the practitioner. It allows a taxpayer to claim additional expenses in a closed year where there is a net operating loss. Apparently what works for the Service should, as in my case, work for the taxpayer. ☆

Both buyer and seller face tax traps in covenants not to compete

by **T. GRAYSON MADDREA**

Poorly-drawn covenants not to compete have cost many taxpayers a lot of money. Because facts and proof of intention are so important in determining the tax outcome, the Commissioner can attack either buyer or seller on any one of several grounds. The problem is further complicated by the fact that buyer's and seller's interests, taxwise, are usually antagonistic. This article discusses what makes a covenant valuable, how payments for it can be made deductible, effect of death of seller, and other elements necessary to avoid undesired tax effects.

AGREEMENTS NOT TO COMPETE are sometimes highly legitimate instruments used to assist in the sale of a business, and sometimes tax tricks used by the courageous to get a tax benefit that is not justified by the facts. Where this situation exists, the Commissioner can be expected to be tough on all comers.

Two factors generally indicate legitimate use of the covenant, or agreement, not to compete. One is the fact that the business was built up by the seller personally, presumably as a result of certain specific talents he possesses. The other is that the seller is personally responsible for a considerable part of the sales of the business being sold. In either of these cases it is fairly obvious that ordinary prudence requires the buyer of the business to protect himself against the seller re-entering the same business to compete with the buyer.

In such a situation, the noncompetition agreement has a business purpose and value. But in other cases the buyers would not suffer from competition by the sellers. For example, the purchasers of a business with valuable and well-known trade names or franchises or an established goodwill should not be permitted to allocate part of the purchase price to an agreement not to compete, because no real damage could result from the seller's activities.

The taxwise buyer does not want to allocate part of the purchase price to the goodwill acquired by a fixed-period covenant not to compete. He would rather deduct it over its life. To do so, the agreement not to compete must be effective for a definite period of time. If the buyer pays the entire cost in one sum, the amount should be amortized ratably over the life of the agreement.[1] If the payments are made periodically over the life of the agreement, they should be deducted when paid or accrued.

The taxwise seller's objects are exactly opposite. He wishes to allocate as little of the proceeds of this covenant as possible because such proceeds were held to be ordinary income in the *Hamlin Trust* case.[2] If he receives the whole price of the agreement in one year, he may very well be subjected to high surtax rates. If the seller is planning retirement, however, he is usually willing to accept payment ratably over the life of the agreement.

Form and procedure

Buyers who demand a covenant not to compete must be very careful of the forms they use in the transaction. The use of a poorly drawn form can easily lead to the loss of a deduction for the payments made under the agreement. In the *Wilson Athletic Goods* case,[3] the Tax Court held that covenants which are included in a general contract of sale of capital stock are not separable from goodwill and that payments which are not assigned a separate value are not deductible. This ruling was overruled by the Seventh Circuit,[4] which said: "it is immaterial whether the contract did or did not define a specified amount as the value of the covenant."

In the *Payne* case,[5] no separate value for the covenant was discussed in the negotiations or mentioned in the original signed contract. The Tax Court held that the noncompetition agreement was incidental, and it allowed no amortization for it, even though a dollar value was assigned to it in a revised contract. This view is sound. The later amendment of the contract indicates the assignment of value to the covenant was an afterthought for the tax convenience of the purchasers.

In the *Dauksch* case,[6] another device was attempted. After the contract of sale omitted assigning any value to the covenant, the buyer allocated on his books the purchase price between the covenant and other assets. Such allocation did not justify a deduction.

Distinction from goodwill

For Federal income tax purposes, amortization of goodwill is, of course, not an allowable deduction. Because the life of goodwill is practically indeterminable, the courts are vigilant to prevent purchases of goodwill masqueraded as payments for noncompetition. But detecting the wolf beneath the sheep's clothing is not easy, even after all the facts are examined. Discussing this problem in the *Wilson Athletic Goods* case, the Tax Court, holding that no part of the sales price was for the covenant not to compete, said: "Good-

[1] Gazette Tel. Co., 19 TC 692, aff'd, 209 F.2d 926 (10th Cir. 1954).
[2] 19 TC 718 (1953), aff'd 209 F.2d 761 (10th Cir. 1954).
[3] 13 TCM 913; see also Payne, 22 TC 526.
[4] 222 F.2d 355.

will is not restricted to trade names or customers lists . . . and included a coordinated and working office and organization, tradition, habit, etc. . . . This going business value was what petitioner was endeavoring to protect when it obtained . . . the covenants not to compete . . . The two items are not severable."

Even when the purchase price of a business is in excess of the fair value of its assets, a mere allocation of an amount (even in the contract) to the covenant not to compete is not enough. The facts must justify the existence of possible competition. For example, in the *Payne* case, the sellers did not live in the community and devoted only part time to the business operations; all of the sales price was attributed to the capital stock. The Tax Court stated that the allocation of $100,000 to the covenant was mere "window dressing" to enable the purchaser to obtain tax benefits.

If the earnings of the business are meager and other evidence indicates that the business actually has no goodwill, the amortization deduction for noncompetition may be allowed.[7] In the *Wilson Athletic Goods* case, taxpayers testified that they would not have bought the business at the price they paid if there were no covenant. The circuit court held in its reversal of the Tax Court that "assurance of noncompetition was the important element of the entire transaction."

Periodic or lump-sum payments

Periodic payments under the covenant seem to present the most tax advantages. This method also has an additional advantage. The buyer can stop payment if the seller breaches. For this reason, the seller of goodwill is more apt to demand payment in full before he turns over his business.

In the *Carboloy* case,[8] periodic payments over a seven-year period met the test and were held deductible, even though they ranged from $175,000 to $300,000. If the payments are determined as a percentage of the sales or net profits, the reality of the covenant may be strengthened. A requirement that the seller be available for consultation when requested may also cement him more firmly to the business. Some agreements require the seller to serve on the new board of directors for the duration of the covenant, if the stockholders request it.

Death of seller before expiration

None of the cases cited discussed or ruled on the tax treatment of payments made or to be made if the seller dies before the contract expires. It would seem that if a lump sum was paid for the covenant at the time of sale, the seller's death would have no affect on the ratable deduction, but that some problems might arise if the payments were made periodically. Some contracts anticipate this possibility by providing for continued payments to the seller's heirs or estate. This provision protects the seller, but one question arises for the buyer: how could the deceased possibly compete? The courts would probably consider the intent and facts concerning the validity of the covenant at the time it was executed, regardless of later events, and such a provision for continued payments would merely be a procedure employed to assure payment of the total amount. It is generally believed that the name and reputation of a person who has built up a successful business could be competition in itself, particularly in the hands of that person's widow or son. The buyer should therefore take the precautionary measure of providing for such a contingency.

Under a periodic-payment agreement, the buyer should not let the seller go too far in his desire to protect his estate in case of his death. Any attempt to assure payment by the use of collateral or negotiable paper may be used by the Commissioner to prove that the payments are for the purchase of a capital asset rather than the giving up of the right to compete.

In determining whether the facts will substantiate an agreement not to compete, the age, health and activity of the seller at the time of sale should be considered. In the *Hamlin Trust* case, in which the agreement was upheld, the seller was 70 years of age, in good health and had no intention to retire, and the agreement was for ten years and called for a lump-sum payment. In the *Dauksch* case the taxpayer bought two insurance agencies. The first he purchased from his partner who had suffered a cerebral hemorrhage the year before, but had made a partial recovery. This agreement was upheld. The second purchase was from a 73-year-old man who had not solicited customers in several years; this agreement was disallowed. In the *Burke* case,[9] the seller, who was in poor health was advised to retire, later started another similar business outside the covenant area. This agreement was disallowed.

"Reasonableness" is important

It is natural for tax advisors to consider "reasonableness" when considering deductible amounts. One guide to "reasonableness" is to draw comparisons. In the subject we are discussing we may compare the price paid for the covenant with the price paid for physical assets or with prior years' income. A study of the cases decided indicates that in only the *Dauksch* case did the court consider this issue. The comparison was made with the amount of prior years' gross income in an insurance business. Even in this case, the covenant was valued at $25,000 and the physical assets $5,000. In the *Carboloy* case, the agreement was valued at a maximum of $300,000 and the physical assets at $13,500. In *Hamlin Trust* the allocation was $150 per share for stock and $50 per share for the covenant. In *Toledo Blade Co.*, the agreement was valued at $780,000 and the trade name at $100,000. It is believed that in the cases in which disallowance occurred, the decision was made on facts other than the allocation of amount to the covenant. However, this factor is one in a series of tests which may be considered by the Commissioner and the courts. It is best not to have the value of the covenant considerably out of line with the gross

[5] 22 TC 526; see also Harold J. Burke, 18 TC 77.
[6] Dauksch v. Busey, 125 F. Supp. 130 (S.D. Ohio 1954).
[7] Francis Silberman, 22 TC 1240.
[8] Carboloy Corp., 2 TCM 413.
[9] 18 TC 77.

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TAX ARITHMETICS

INSTRUCTIONS for the Japanese income tax include the following sentence:

"Take the appraised value of your house, multiply it by the floor space you occupy, divide it by the total floor space, multiply the result by the number of days during 1955 in which you were a resident taxpayer, divide the answer by 365, multiply that by 108, and divide the answer by 100."

or net income of the business being purchased, depending on the type of operation. Certainly the price of the covenant cannot be more than a prudent businessman would pay in an arm's-length transaction. As a rule-of-thumb guide, it is suggested that the covenant should be valued at not more than one to three years' net income, before taxes, based on past experience. If the value is computed on gross income in a personal-service type of business, a one to one-and-one-half-years' gross business may not be excessive. ☆

Tax Court follows narrow definition of capital asset in auto dealer case

IN MARCH AND again in May, we discussed in this department the Supreme Court's new definition of "capital asset." In the *Corn Products Co.* case, the Court found that futures contracts, which were true hedges by a manufacturer, were not capital assets. But the Court did acknowledge that its holding was not in accord with the "literal language" of the Code. It would look rather to the intent of Congress (as it saw it) to tax profit from everyday business transactions as ordinary income.

Now the Tax Court indicates that it will also ignore the literal words, that it will follow the intent of Congress in the old problem of auto dealer's demonstrators. Strictly speaking, the Tax Court's words in the *Johnson-McReynolds Chevrolet* case (see summary, page 89) are obiter dicta. Having decided that the taxpayer had failed to show that the cars were not held for sale to customers, the judge added that in any event the Supreme Court would interpret "capital asset" narrowly. This addition was not necessary to the decision. It should also be noted that this decision was not reviewed by the entire court.

Here's what Judge Rice had to say:

Petitioner contends that the sale of the cars was the sale of property used in its trade or business within the meaning of Section 117 (j), and that the gains therefrom are taxable as capital gains. The respondent, on the other hand, contends, in support of his determination that such gains were ordinary income, that the cars were the stock-in-trade of petitioner's business, held for sale to its customers, within the meaning of Section 117(j).

The respondent's determination that the automobiles in question were the stock-in-trade of petitioner's business is presumptively correct, and we think on this record that the petitioner has failed to overcome that presumption. The issue is entirely one of fact, and the two essential facts which petitioner failed to establish are: (1) that the automobiles were not property of a kind includible in inventory if on hand at the close of the taxable year; and (2) that the automobiles were not held by it primarily for sale to customers in the ordinary course of its trade or business . . . . The automobiles here in issue were acquired by it originally as new cars and entered on its books in the new car inventory account. They were thereafter transferred to the so-called company car account when assigned to officials and salesmen. Clearly, the cars were initially acquired from General Motors for sale to customers. We think that the best that can be said on this record is that for a period of approximately a year or less the automobiles in question were temporarily assigned to salesmen and company officials for their use, but that the essential purpose for which they were originally acquired was never changed.

Moreover, the position which the petitioner takes, on this record, seems to us contrary to the basic Congressional purpose in providing for a capital gains tax. As the Supreme Court noted in *Corn Products Co. v. Commissioner*, 350 U. S. 46 (1955), at page 52:

" . . . the capital-asset provision of Section 117 must not be so broadly applied as to defeat rather than further the purpose of Congress. . . . Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by Section 117 applies to transactions in property which are not the normal source of business income. It was intended 'to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions.' . . . Since this section is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly. This is necessary to effectuate the basic Congressional purpose. . . ." ☆

New accounting decisions this month

CASES INVOLVING CAPITAL GAINS v. ORDINARY INCOME

Profits received after sale of stock ordinary income. After a number of disagreements with other stockholders, a taxpayer who was a minority stockholder and creditor agreed to sell his stock to the corporation, a motion-picture company. For the stock he received a right to participate in profits from future pictures and to be employed in such productions. The court holds that payments were not part of the purchase price for the stock but a participation in profits, hence ordinary income. *Finney*, TCM 1956-247.

Guaranty of inventory given for stock is additional cost, not expense. Taxpayer transferred its frozen-food inventory in return for stock of the transferee, and agreed to indemnify the transferee against any loss on the inventory. Thereafter it ceased to engage in the frozen-food business. Amounts which it was required to pay under the guaranty are, the court holds, consideration for the stock. They were not expenses because the guaranty was not given to protect or develop the taxpayer's business. *Flint and Fulton, Inc.*, TCM 1956-252.

Employer's "shop rights" in patent do not preclude capital gain on sale by employee. For a royalty of 1% of sales, taxpayer, an electrical engineer, assigned to his employer his patent on a waste-disposal unit which he had developed on his own time but on company premises and with the help of two company employees. Because the patent was developed at the corporation's ex-

pense, the Commissioner asserted, the employer had such a substantial interest in the patent that the taxpayer could not have made a sale of "all substantial rights," taxable as a capital gain under the 1939 Code. The court holds, however, that the employer's "shop rights" would give it merely a nonexclusive right to use the patent; this is insufficient to dilute taxpayer's substantial rights in the patent. Amounts that he received as royalty payments are taxable as capital gain and not as ordinary income. *Jordan,* 27 TC No. 27.

Agency holds for sale autos temporarily used by it. Taxpayer, an auto dealer, acquired autos as inventory and temporarily assigned them to company officials and salesmen for their personal use. Upon their sale, it realized ordinary income. [See page 88. *Ed.*] *Johnson-McReynolds Chevrolet Corp.,* 27 TC No. 31.

Loss on stock by nondealer a capital loss. A sale of stock resulted in a capital loss rather than ordinary loss. Taxpayer-corporation was not a "dealer," even though it was authorized by its charter to deal in securities. *Southern Trading Co.,* TCM 1956-246.

Capital gain on sale of trade name though price was percentage of sales. [*Acquiescence*] When taxpayer organized a corporation to manufacture and sell swim suits, it was her understanding that she was to contribute her trade name and inventions and that the other stockholder was to contribute cash. In settlement of a dispute arising under this agreement, taxpayer agreed to accept 1% of sales for her name and patents. The Tax Court found that the settlement was a sale of the trade name and patents. Payments were not compensation for taxpayer's services. The patents and her trade name are capital assets, and the transfer of the right to use them in the U. S. constitutes a sale. *Reed,* 26 TC No., 78, *acq.* IRB 1956-47.

Contractor was frequently paid in bonds; ordinary loss on worthlessness. Taxpayer, a construction company, frequently received payments in bonds. The court holds that these bonds, and lots received on foreclosure of some bonds, were not capital assets because they were held for sale to customers in the ordinary course of taxpayer's business. The bonds here involved were being held for a favorable market. *Union Paving Co.,* DC Calif., 11/5/56.

Ordinary income on sale of inventory of dissolved partnership. Two brothers who had been engaged in the electrical-appliance business as partners transferred all the partnership assets, except for some war-surplus items, to a new corporation. These items they purchased from the partnership for $10,000 and sold in their own names at a substantial profit in the succeeding three years. The proceeds are held to be ordinary income rather than capital gain; the brothers never held the war surplus items as an investment, but only as the stock in trade of a business operation. *Baker,* TCM 1956-241.

Lawyer had ordinary income on sale of lots. In 1944, taxpayer, a practicing attorney, acquired a farm. After he made various improvements, he sold 15 lots in 1947, 57 in 1948, 16 in 1949, and 13 in 1950. Taxpayer also dealt in other real estate. The Tax Court held that taxpayer was engaged in the business of selling real estate in 1948 and 1949. This circuit court affirms. The income is taxable as ordinary income. *Murray,* CA-10, 10/11/56.

"Mortgaging out" is ordinary income. Taxpayer's construction costs were less than the FHA mortgage loans. The excess it distributed to stockholders. The court, without discussing the cases holding contra, merely states that payments were income to the stockholders under Section 22. [1954 Code provides that payments to stockholders out of FHA loans over construction costs are ordinary income. *Ed.*] *Wilshire-La Cienega Gardens Co.,* DC Calif., 8/13/56.

Donee has ordinary income on sale of lots. Five weeks after taxpayer received approximately 200 lots of improved and unimproved real estate as a gift from her parents, she sold two. In a period of 11 months, she sold, in seven transactions, 108½ lots and an entire city block. The court holds that she did not prove that the lots were not held primarily for sale in the ordinary course of a trade or business. *Bistline,* DC Idaho, 11/1/56.

On remand, payments on sale of trademark held capital gain. Under mandate from a circuit court, the Tax Court holds that $75,000 of a total of $200,000 received by taxpayer on sale of a trademark was not ordinary income for cancellation of a distributorship contract but constituted payments for sale of a capital asset. The court also allows taxpayer's basis for a tradename and the full amount paid to officers as reasonable compensation. The Tax Court concludes its opinion: "In holding as we have above, we have done so only because of what appears to us to be the direction of the Court of Appeals." *Vita-Food Corp.,* TCM 1956-249.

Property "available" to prospective purchasers not capital. Taxpayer, an attorney, testified that the land he held was for sale if the price was right. For 20 years, most of his income was from the sale of land. The court holds that taxpayer did not meet the burden of proving that the land was held primarily for investment rather than for sale. *Bistline,* DC Idaho, 11/1/56.

Capital gain on leases held as investment. The court finds that taxpayer held two types of leases: "commission leases" and "investment leases." The commission leases he purchased for resale to oil companies, and the investment leases he developed himself. Sale of the investment leases resulted in capital gain. *Sledge,* DC Tenn., 11/26/56.

County Commissioner had ordinary income from sale of lots. In 1942, taxpayer acquired 100 acres of land adjacent to a highway. He spent $80,000 on improvements so that he could sell the lots. Though he never devoted half his time to this activity, about 65% of his income from 1945 to 1949 was derived from profits resulting from the sales of these lots. The court finds taxpayer was engaged in the business of selling lots. The profit is ordinary income, not capi-

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tal gain. *Thompson,* Ct. Cl. 11/7/56.

Wash-sale rules don't apply to shares retained though part of block is sold within 30 days. According to the wash-sale rules of the Code, no deduction is permitted for the loss on the sale of a stock if substantially similar stock is purchased within 30 days of the sale. The IRS holds that this rule does not apply to shares purchased in one lot less than 30 days before the sale of part of them. The rules apply to a "new acquisition," "repurchase" or "buying back" within the required period. *Rev. Rul.* 56-602.

Transfer of patent was sale despite payments based on use. Taxpayer, an engineer, granted an exclusive license to make, use and sell machines embodying his invention. In return he received payments based on use. The litigation was practically completed prior to the enactment, in 1956, of an amendment to the Code providing retroactively that a transfer of all substantial rights to a patent shall be treated as a sale of a capital asset despite payments based on use. The Commissioner argued that the transfer was not a sale; the mode of payment, he said, disproved that contention. The court reviews the legislative history and holds that taxpayer qualified under that provision for capital gain treatment. *Philbrick,* 27 TC No. 36.

Tools were not held primarily for sale. The facts and the precise issue in controversy are not reported, but apparently the taxpayer had sold certain tools which the Commissioner claimed were held primarily for sale. The charge to the jury listed these factors as relevant: the evidence surrounding the holding and sale of the property, continuity of sales, sales-related activity of the seller, the extent of the transactions, and the fact that the property need not have been acquired primarily for sale to customers in the ordinary course of business. The jury does not find that the taxpayer's primary purpose at the time at the rental contract was to sell the tools. *Houston Oil Field Material Co.,* DC Tex., 8/2/56.

ACCOUNTING METHODS

Cash-basis taxpayer can't deduct accrued income tax for Section 102 tax (old law). The Commissioner assessed a surtax under Section 102 for 1946. The corporation's 1945 income taxes, paid in 1946, amounted to $142,000. Its 1946 income tax of $726,000 was not allowed as a deduction in determining the income subject to surtax for 1946. The 1939 Code provision allowing deduction of taxes "paid or accrued" must be interpreted, as in other parts of the Code, as meaning according to taxpayer's method of accounting. The Supreme Court so held in *Olympic Radio & Television* in denying the deduction of taxes paid by an accrual-basis taxpayer in computing operating losses. [1954 Code allows a deduction for accrued income tax.] *Harry M. Stevens, Inc.,* CA-2, 11/9/56.

Commissioner's adjustments proper on change of accounting basis. Taxpayer was a member of a partnership which, though it changed its books from a cash basis to an accrual basis in 1946, continued to file tax returns on a cash basis. The Commissioner recomputed income on an accrual basis. The court holds that taxpayer failed to prove that an error in the partnership books brought about a duplication of reported sales for 1947 or that the Commissioner erred in his determinations of opening and closing accounts receivable, accounts payable, and inventories for 1946 and 1947. *Cobleigh,* TCM 1956-261.

Stud fees income when received though contingent liability remains. A horse breeder bred mares in the springtime. The foals were born 11 months later. Under the terms of the breeding transactions, a live foal was guaranteed. Although the fees were collected in the year of breeding, taxpayer reported them as income in the following year when the foals were born. The court holds the fees were income in the year of breeding and receipt. Whether taxpayer was on the cash or accrual basis was immaterial. Any refunds made in a subsequent year could be deducted in the year the refund is made. *Whitaker Estate,* 27 TC No. 44.

Cash basis can be used for long-term construction contracts. Taxpayer-corporation, engaged in the construction business, reported on the cash basis. It had no inventories and no heavy equipment. During 1949-50, it constructed three apartment areas and one shopping area for related companies. It did not receive or include in income until subsequent years the large sums due it for the construction, though it did record the expenses during the years of construction. The Commissioner's contention that the delayed payments distorted income unless the accrual method were used is overruled. The court quotes with approval *Osterloh* (37 F2d 277, 9th Cir.), on the meaning of "clearly reflecting income." "In our opinion," it says, "all that is meant is that the books shall be kept fairly and honestly; when so kept they reflect the true income of the taxpayer." *Hunt Engineering Co.,* TCM 1956-248.

Premiums accruable when amount and liability are reasonably certain. Taxpayer, a common carrier by motor transport, carried a liability-insurance policy which was canceled in 1948 after an accident claim. Under the terms of the policy, the insurer was authorized to compute a retroactive premium in addition to the standard premium charge. The amount of the retroactive charge was limited. In 1950, the insurer set up a reserve to cover the claim and notified taxpayer of that fact since the reserve controlled the amount of the additional premium. It was then clear that the retroactive premium would then be the maximum. Taxpayer sought to accrue the expense in 1952, the year in which the claim by the damaged persons was finally settled. The court denies the accrual in 1952 because all the events which fixed with reasonable certainty the fact and amount of the premium liability occurred in an earlier year. *Midwest Motor Express Co.,* 27 TC No. 18.

Can't split recoveries in suit on several issues; over-all it was reduction of loss. [*Acquiescence*] As a result of a stockholder's derivative action, taxpayer received a $15 million recovery based on many allegations of damage suffered. The Commissioner allocated the recovery to various items and determined a taxable profit on many of these. The Tax Court held that there was no justification for such a procedure. Taxpayer had lost $25 million all in all, and the recovery of $15 million represented a recovery of capital, not income. *Pennroad,* 21 TC 1987, *acq.* IRB. 1956-47.

Deductions denied for contested liabilities. Taxpayer refused to pay an archi-

tect his $32,000 fee for services in connection with a proposed remodeling of a hotel. It claimed that the remodeling had been abandoned and the hotel sold. The architect brought suit in 1947. The court rendered a decision in favor of the taxpayer on technical grounds. The Commissioner later disallowed the accrual of the fee in 1946 because the liability was then contingent and contested. The court concurs. It also disallows the accrual of the cost of elevator doors because taxpayer denied the liability. *Flint and Fulton, Inc.* TCM 1956-252.

Withheld "dealer's reserves" part of proceeds of notes. An auto dealer on the accrual basis is taxable on the entire amount of the selling price of notes sold to a bank, including those amounts withheld by the bank as "dealer's reserve." The Tax Court says merely that it follows its own rule in *Johnson*, 25 TC 123, though the Fourth Circuit reversed (233 F2d 952). *Brodsky*, 27 TC No. 23.

Can't use installment method; payment dates not fixed. Under the terms of a sales contract with a dealer, taxpayer-manufacturer is entitled to the price when the goods are resold but not later than a specified date. The Service holds the manufacturer may not use the installment method, since no provision was made in the contract for payment of fixed amounts at stated intervals. *Rev. Rul.* 56-587.

Government took over buses; compensation ordinary income when received. During 1944-45, when negotiations with the union became deadlocked, the U. S. took over control of taxpayer's transportation system. After Federal control ceased, taxpayer unsuccessfully sought compensation from the Office of Defense Transportation. In 1948, Congress established a commission to study the situation, and in 1952 taxpayer received $29,000 from the U. S., based upon an award determined by the commission. The court holds the full amount was accruable in 1952. At no earlier time was there certainty that taxpayer would receive compensation. The award was ordinary income, not, as the taxpayer argued, capital gain on an "involuntary conversion." The property was not taken and converted; it was merely used. The award was a substitute for rental. *Midwest Motor Express, Inc.*, 27 TC No. 18.

WHOSE INCOME IS IT?

Sales of borrowed securities were for lender. [*Acquiescence*] Taxpayer was a retired senior partner in a brokerage firm which was required by the Exchange to increase its capital. He entered into an agreement with a customer whereby her securities were transferred from her account to taxpayer's capital account. This transaction was referred to as a loan and was secured by a mortgage on taxpayer's home. As provided in the agreement, the securities were actively traded, always with the specific consent of the customer who reported the gains and losses in her return. The Commissioner treated them as short sales by the taxpayer. The Tax Court found that they were sales by the customer, not the taxpayer. *Tobey*, 26 TC No. 76, *acq.* IRB-47.

Income from auto-insurance commissions was taxable income to general manager of car dealer. The general manager and principal stockholder of taxpayer, a car dealer corporation, sold auto insurance as an individual and paid to the corporation the expenses incident to the insurance-brokerage business. The Commissioner asserted the commissions were income of the corporation and a dividend to the stockholder-manager. The court holds the commissions were income of the individual. The corporation's charter did not authorize the sale of insurance and under South Carolina law a corporation could not be licensed as a broker. *Waits Motors, Inc.*, DC SC, 11/29/56.

Rental income not taxable to holder of purchase option. Taxpayer obtained a five-year option to buy property. A deed and a bill of sale were executed and placed in escrow. Meanwhile a corporation in which taxpayer held a minority interest occupied and leased the property for five years, at $1,500 a month. Toward the end of the lease period, taxpayer exercised his option. The Commissioner determined that the property was purchased by taxpayer at the time the option was obtained, and that the rent was therefore taxable to him. The court holds this was a perfectly normal option arrangement; title did not pass until five years later when taxpayer exercised the option and complied fully with its terms. *Niederkrome*, TCM 1956-255.

ERROR ON 1956 FORM 1120

The IRS announced that there is an error on the front page of form 1120 for 1956. In Question L the reference should be to the calendar year 1956, not to 1955. As printed this is how Question L reads: Did the corporation make a return of information on Forms 1096 and 1099 or Form W-2 for the calendar year 1955?

Income between contract date and sale date belongs to seller. [*Acquiescence*] Taxpayer was the assignee of a contract entered into May 12, 1949 for the purchase of a hotel at a flat price. The contract provided that the closing would be held one month later, at which time any net income earned between May 1, 1949 and June 15, 1949, subject to the customary closing adjustments, would be credited to the buyer. The Commissioner contended that taxpayer-buyer was taxable on this income because it received it. The court holds otherwise; the greater bundle of rights, including title, possession, management and the substantial burdens and benefits of the ownership of the property were all still possessed by the seller at the time the income in question was earned. *2 Lexington Ave. Corp.*, 26 TC No. 101, *acq.* IRB 1956-46.

Profits from hotel in name of family members taxed to real owners. Two men negotiated for the purchase of hotel property. After they paid earnest money on a contract to purchase, they decided that the property should be held by a partnership composed of one's wife and the other's sister. Though the two women signed a partnership agreement, they took no part in the negotiations concerning the sale of the hotel, nor did they invest any of their own funds. The court concludes the men, and not the women, were the actual partners. It taxes each man on one-half of the hotel income, but it rules against fraud penalties for the failure to report the partnership income. The Commissioner did not prove the men had a fraudulent intent. *Michael*, TCM 1956-257.

Corporation found not mere title

holder; it should have reported income. Taxpayer was assessed as transferee of a corporation which held title to a building it sold. The corporation filed no returns and alleged it held bare legal title, deliberately taken to avoid personal liability. All funds passed through a bank account in the corporation's name, and leases were executed in the corporate name. The corporation should have filed returns reporting the operation and finally the sale of the building. Nonfiling was due to willful neglect and penalties are assessed. *Given,* CA-8, 11/29/56.

DEPRECIATION

Can depreciate incomplete vessel used as warehouse. Taxpayer purchased a partially completed vessel in 1945, intending to complete and use it as a barge. Because it had difficulty in arranging financing, taxpayer halted work on the vessel in 1946. It then used the vessel to store equipment, and the machine shop inside to repair other barges and tugs it owned. Crew members of boats being repaired often ate, lived and slept aboard the incomplete boat. Interest and insurance costs were capitalized from 1946 through 1950. In 1951-1953, they were expensed, but no depreciation was claimed. Taxpayer now claims depreciation is allowable and asks refund. The court holds that depreciation is allowable. The vessel was used in the trade or business of the taxpayer. *Gulf Atlantic Transportation Co.,* DC Fla., 11/5/56.

Accelerated depreciation for injured race hose denied. In 1950, taxpayer's race horse bowed a tendon and taxpayer sold her for $1,000 after he determined that she was valueless as a racehorse. The Commissioner allowed a normal depreciation deduction for 1950 on a straight-line basis and determined that the difference between the adjusted basis and the sales price was a capital loss. The court finds that taxpayer was in the racing business. [It may be inferred, though it is not stated, that taxpayer had gains on other assets used in the business (capital under 117(j)) against which the Commissioner netted this loss. *Ed.*] Taxpayer contended he was entitled to the difference as an ordinary loss, it being in the nature of accelerated depreciation. The court denies an ordinary-loss deduction as the useful life had been shortened by an accidental injury, not by depreciation (i.e., exhaustion, wear and hear). *Whitaker Estate,* 27 TC No. 44.

Excessive use does not justify accelerated depreciation. Taxpayer was a member of a partnership which claimed accelerated depreciation on its machinery and equipment in 1946, 1947, and 1948 on the ground that the machinery was used on a 24-hour basis those years. The court denies the claim, holding that excessive use does not in and of itself establish a right to accelerated depreciation in the absence of a specific showing that the life expectancy of the machinery was materially reduced by the excessive usage. *Minkoff,* TCM 1956-269.

End-use test not applicable in determining depletion rate for quartzite. Although all the deposits quarried and sold by taxpayer were quartzite within its commonly and commercially accepted meaning, the Commissioner argued that taxpayer was not entitled to the 15% quartzite depletion deduction but to the general 5% allowance because the end-use of most of the deposits sold was for construction rather than refractory purposes. The court allows the 15% rate. As the Code had specifically provided a stated rate for quartzite, the end-use of the mineral was immaterial. *Spencer Quarries, Inc.* 27 TC No. 43.

Lime defined for percentage depletion. The Service defines chemical grade limestone (15% depletion) as any deposit used (or sold for use) as lime after calcination. Any stone not calcinated is not chemical grade limestone and can be allowed percentage depletion of only 5%. [The 1954 Code prescribes an end-use test for determining which rate applies; some courts have held the end-use test improper under the 1939 Code. *Ed.*] *Rev. Rul.* 56-582.

Street improvements cannot be depreciated. Taxpayer constructed a housing project, paved the streets, and put in street lighting. The improvements are capital expenses, but they are not subject to depreciation. They can be deducted when the project is sold. *Baldwin Gardens Co.,* DC Calif., 8/13/56.

DEDUCTIBILITY

"Insider" can deduct payment of profit possibly refundable under SEC rules. The investment banking company in which taxpayer was a senior partner dealt in shares of Shamrock Oil, in which taxpayer was a director and stockholder. Taxpayer denied that he was required by the Securities Exchange Act to refund to the corporation his share of income realized on the deal as "insider's profits." To avoid litigation, and to protect his business reputation, taxpayer paid the corporation the maximum it could recover under the Act. The court allows the payment as a business expense. There was considerable doubt of his liability; hence, allowance would not frustrate sharply defined public policy. If there was a violation of the law, it was unintentional and was not due to a lack of reasonable care. Three judges dissent. They note that deduction has been disallowed in other similar cases on the ground that repayment is in the nature of a penalty, regardless of the faith of the transgressors. *Marks,* 27 TC No. 51.

Contributions to hospitals cannot be deducted as a business expense. Taxpayer, a surgical-supply house, made substantial contributions to hospitals which had been customers before the contributions and continued to be so thereafter. The court holds that the amounts are not business expenses but can be deducted only as contributions subject to the 5% net income limitation. *Stover Co.,* 27 TC No. 48.

Loss of exclusive rights to news service not deductible. A publishing corporation which had paid for a membership contract in the Associated Press lost its exclusive rights to the AP service in 1945 when the AP amended its bylaws to eliminate the noncompetitor provisions. The corporation was denied a tax loss in 1945. The circuit court affirms the Tax Court decision: there was no realized loss, though the value of the rights declined. *Independent Publishing Co.,* CA-4, 11/3/56.

No deduction because AP lost monopolistic value. The N. Y. Sun is not permitted to deduct the cost of its AP membership. That membership lost all its value when the Supreme Court invalidated AP's monopolistic practice of limited membership, and when the AP voluntarily changed its bylaws. The court holds there was no justification for the deduction in the absence of a sale or other disposition of the membership which taxpayer still owned and used in

its newspaper business. *N. Y. Sun*, 27 TC No. 33.

Cost of geological survey deductible on abandonment. In 1946, when taxpayer considered buying oil interests, it paid a geologist to survey the properties. The fees it paid the geologist are deductible in that year because it abandoned the idea of purchasing the interests. *Southern Trading Co.*, TCM 1956-246.

Loss denied for year of embezzlement. In 1946, taxpayer's agent deposited in his own bank account $30,000 which had been remitted to taxpayer by a customer. The fraud was not discovered until 1950 when the customer brought suit for his merchandise. In 1953, taxpayer paid $20,000 to settle the claim. Recovery from the agent was impossible. Since the taxpayer was on the accrual basis, it filed claim for refund of 1946 tax. This the court denies. A loss is not inevitably sustained when embezzlement occurs; restitution may be made. The court holds that $20,000 is properly deductible in 1953. *Ismert-Hincke Milling Co.*, DC Kans., 10/16/56.

Air-route development costs not amortizable. In connection with the acquisition and development of air routes, the cost of surveys, maps, legal services, operating planes, pilots' wages, etc. are nonamortizable capital expenditures. They may be charged off only when the route is abandoned. *Rev. Rul.* 56-600.

Loss on notes induced by fraud allowed long after year of debtor's bankruptcy. [*Acquiescence*] Taxpayer was the owner of notes executed in 1931. In 1933, the debtor was adjudicated bankrupt and in 1934 was discharged. As the indebtedness arose out of the debtor's fraud, the indebtedness survived the bankruptcy discharge. Nothing was paid on the notes, and in 1950 taxpayer was given $500 by another creditor to induce him to sue on the notes. In 1951, taxpayer secured judgment on six of the notes. This judgment was affirmed in 1952. In 1956 the Tax Court refused to allow a debt loss for 1950; it held that the $500 received in 1950 to institute suit was a return of capital, not income. A nonbusiness bad-debt loss of $5,500 for the notes ($6,000 less $500 return of capital) was allowed in 1952. *Alexander*, 26 TC No. 106, *acq.* IRB 1956-47.

North Dakota sales tax on business property a business expense. In determining adjusted gross income, the North Dakota sales tax paid upon the purchase of property to be used in a business is deductible as a business expense if the purchaser does not elect to capitalize such amount. *Rev. Rul.* 56-611.

Renovation costs capitalized; they were an integral part of an over-all permanent betterment. After he purchased property for $14,000, of which $12,000 was allocable to the building, taxpayer expended $13,500 in renovating the building. The court holds the expenditures were made pursuant to an over-all plan to improve the property, and as each item was an integral part of the over-all permanent betterment, the total amount represented capital expenditures, no part of which could be deducted during the year as repairs. *Cobleigh*, TCM 1956-261.

Can amortize discount on debentures issued for stock. The court finds that taxpayer issued its debentures for outstanding preferred in a tax-free exchange. Taxpayer's right to amortize the discount is not lost merely because the exchange was tax-free and the consideration was stock instead of cash. *Industrial Development Corp.*, DC Ill., 7/17/56.

Cost of proxy and option must be apportioned to allow deduction for amount attributable to proxy. Taxpayer paid $50,000 to another stockholder for the right to acquire the latter's stock upon his death, and also to vote that stock during the owner's lifetime. Taxpayer owned 15% and was trying to prevent a proposed merger. Taxpayer claimed the entire cost as a nonbusiness deduction, but the district court held that the option was a capital asset. Failure to submit evidence apportioning the price between the proxy and the option precludes taxpayer from claiming any part of its cost as a deduction. This court affirms. *Lawrence*, CA-1, 11/20/56.

BAD DEBTS

Owner of inherited real estate not in business of making loans. Taxpayer's financial interests were centered in real-estate holdings inherited from his parents. He is denied a business bad-debt deduction for loans totaling $23,000 to a corporation which he organized to build boats. The court could not find a proximate relation of the debt to any trade or business carried on by him. *Lasker*, TCM 1956-242.

tax problems?

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Stockholder-guarantor's payment deductible as nonbusiness bad debt. Taxpayer guaranteed the notes of a corporation, and 18 months after its liquidation (at which time he was sole stockholder) he was required to pay the debt himself. The Tax Court and the Eighth Circuit agreed that the loss was nonbusiness. The Supreme Court holds that: (1) the loss arose out of a debt and can be allowed only under the bad-debt provisions of the Code, not as a business or profit-transaction loss; (2) the debt involved is the original obligation—of full value in the creditors' hands because of the guaranty; the guarantor acquires this same debt when he pays the obligation and it "becomes" worthless in his hands; and finally (3) Congress intended to limit losses on nonbusiness loans by treating them as short-term capital; no distinction should be made between a direct loan and a guaranty.

Justice Harlan dissented. He said that (1) the finding that the worthlessness occurred in taxpayer's hands is unrealistic; and (2) it is not clear that Congress intended to include guarantors' losses in its provisions covering nonbusiness bad debts. *Putnam*, Sup Ct, 12/3/56. [See discussion on p. 66. *Ed.*]

Advances to brewery by beverage distributor a nonbusiness debt. A partnership in the business of distributing beverages at retail purchased the stock of a brewery to insure for itself a source of beer which was then in short supply. Later when there was no longer a shortage the partners made advances to the corporation to enable it to engage in a new venture, the manufacture of ale,

primarily for distribution by the partnership. When the sales of all fell off sharply, the partners abandoned the business. They claimed a business bad-debt deduction for the unpaid advances. In this case the Tax Court holds the debts were nonbusiness debts and could not be used in computing a net operating loss carryback since (1) the advances were not part of the partnership's cost of purchasing ale; (2) the partners were not engaged in promoting, organizing, or financing corporations; and (3) the advances were not proximately related to the partnership's beverage-distribution business. *Koppelman,* 27 TC No. 42.

Advances to corporate newspaper venture nonbusiness bad debts. Three brothers in the cattle business formed a corporation to start a newspaper. They advanced $84,300 to keep the newspaper going, but it was a losing proposition from start to finish. The brothers contended that the corporation never came into existence or was a mere sham and that all the expenses and losses were their own. The court finds the paper was published by a valid corporation which was a separate taxable entity. The advances are held to be nonbusiness bad debts. As the debts were only partially worthless in the taxable year, no deductions are allowed. *Skarda,* 27 TC No. 15.

WHAT IS INCOME?

State war bonuses nontaxable. State bonuses paid to World War II and Korean veterans are nontaxable gifts. As such, they are not includible as income by the recipients of the bonuses. *Rev. Rul.* 56-610.

Payment to widow of corporate officer was a gift. During 1951, '52, and '53, the taxpayer-widow received payments from the company of which her husband had been president. In a brief opinion, giving few facts and not discussing the reason for the finding, the court holds that these payments are not income to the widow. They are gratuities. *Graves,* DC Tex., 11/23/56.

Value of stock received for commissions is income. In July 1944, taxpayer, transferred orders in excess of $300,000 to a corporation in which he was sole stockholder. The corporation recorded as a liability $20,000 commissions payable thereon and issued stock in satisfaction for the liability. In 1945, taxpayer earned an additional $20,000 commissions for which the company issued notes. In January 1946, stock was issued to taxpayer and charged against the note liability. The court holds the stock was income to taxpayer in 1944 and 1946 in the amount of $20,000 each year. Taxpayer failed to prove that the first stock was received as part of a nontaxable exchange or that the second $20,000 was income in 1945 when the notes were issued. *Sharpe,* TCM 1956-262.

Uranium stock received as compensation. In 1951, taxpayer received 50,000 shares of uranium stock for promoting the sale of the corporate stock. The court holds the stock was issued in payment of commissions and not as a gift. Taxpayer was therefore required to report as income $12,500, the fair market value. *Haney,* TCM 1956-263.

OTHER DECISIONS

Basis doesn't include write-up by predecessor. Taxpayer acquired land from a predecessor partnership in a nontaxable exchange. The taxpayer entered the land on its records at $126,000, the amount shown on the partnership books. In the course of the revenue agent's examination, he found a journal entry on the partnership books increasing the land account from $35,000 to $126,000 to reflect appreciation in value. As taxpayer could not prove that this increase represented a cost for tax purposes, the basis of the land to taxpayer for purposes of computing the EPT invested capital is $35,000. *Flint and Fulton, Inc.,* TCM 1956-252.

Business loss allowed for abandonment of well. Amounts expended for drilling a water well used for irrigation and other agricultural purposes are nondeductible capital expenditures. Abandonment of the well for bona fide business reasons will be a deductible business loss. *Rev. Rul.* 56-599.

Losses on motion pictures denied. In 1943, taxpayer purchased a film about the Nazis for commercial exhibition. He persisted in attempts to market the film, which he finally sold in 1951. The court denies a deduction for worthlessness in 1945, as taxpayer did not consider the picture worthless upon the fall of Nazi Germany and did not establish that it became worthless at any other time during the year. A deduction in 1945 for the loss of another film was also denied because taxpayer made no effort to obtain recoupment of the price from the unauthorized seller who was not shown to have been insolvent. *Finney,* TCM 1956-247.

Commissions withheld not taxable to cash-basis salesman. In order to make good an excess of advances in prior years over earnings, taxpayer's employer withheld some commissions earned by him in 1949. In 1950, the employer withheld commissions to build up a reserve fund. The Tax Court held the taxpayer had no right to the withheld amounts and therefore was not taxable on them. Any excess of advances over earnings in prior years were taxable then. *Moorman,* 26 TC 82, *acq.* IRB 1956-47.

Oil royalties not proved valuable prior to sale; loss denied. Oil royalties were sold at prices between $40 and $100 during 1946-1948. The Tax Court decided that these royalties became worthless before the year they were sold for nominal amounts. This court affirms. Oil royalties can be worthless even while legal title is retained. *James Petroleum Corp.,* CA-2, 11/13/56.

Contested tax not deductible though paid. An accrual-basis taxpayer paid in 1937 excise taxes which had been assessed in 1936 for 1932 and 1933. Taxpayer claimed a deduction in 1937; in 1941, the Board of Tax Appeals denied the deduction because, it said, the taxes were properly deductible in 1932 and 1933. Taxpayer sued for refund of the *excise* taxes. In 1945, the district court decided for taxpayer; in 1946 the court of appeals reversed, and the following year certiorari was denied. Taxpayer then claimed these excise taxes in its 1947 return. Again they were disallowed, and taxpayer then brought this action for refund. This court rules for the taxpayer, citing *Dixie Pine Products* (320 U.S. 516). Taxpayer cannot deduct the taxes while it is contesting them. Merely by paying the contested taxes, taxpayer cannot avoid application of this rule. Final adjudication is the event that fixes the amount or the fact of tax liability; 1947 was the proper year to deduct these excise taxes. *The Standard Oil Company,* DC Ohio, 10/30/56.

THE TAXATION OF INDIVIDUALS

Personal tax problems

EDITED BY BENJAMIN HARROW, J.D., CPA

How new rules apply to taxation of annuities in typical policy situations

IN DISCUSSING taxation of annuities, one should always bear in mind the reason for their special tax treatment. This reason is simply that payments under an annuity contract are partly a return of principal and partly interest. The law seeks to tax the interest element but to let the principal portion be returned free of tax. If this concept is borne in mind, the rules relating to the taxation of annuities will make sense and will be more easily remembered. Under the 1954 Revenue Code a new approach is taken to obtain this result, and it appears to be fairer, at least to new policy holders. The 1954 Revenue Code purports to allow the holder of an annuity to recover his cost of that annuity over the expected period of payments. How these provisions are applied was recently discussed by Richard Alden, Los Angeles attorney, at the tax forum sponsored by the Title Insurance and Trust Co., Los Angeles.

He cited the example of Mr. White, an executive who is 60 years old and has paid premiums for 20 years on an ordinary-life policy. He decides to convert this policy for an endowment-at-65 policy.

Under Section 1035 of the 1954 Revenue Code, this will be a tax-free exchange, even though he is able to use the cash value of his ordinary-life policy which is in excess of his cost. Section 1035 applies to the exchange of a contract of life insurance for another contract of life insurance or for an endowment or annuity contract as well as other exchanges of specified policies. Mr. White's cost of the ordinary-life policy carries over to the endowment policy.

Lump sum at maturity

When Mr. White reaches 65 years of age, his endowment contract will mature and he will be presented with several alternatives. He can either leave the principal at interest, take the lump sum, take payments for a guaranteed period of time, or take payments for life, with or without a certain period guaranteed. If he takes the lump sum, the difference between his cost and that lump sum will be taxed to him as ordinary income. But under Section 72(e)(3), at Mr. White's option, this gain may be spread over the year of receipt and the two preceding years, if such action will result in his paying less income tax on this gain. Mr. White is also given 60 days after the date of maturity of his policy within which to elect a settlement option without running the risk of being charged with constructively receiving this gain and therefore being taxed upon it.

Mr. White's cost of this particular endowment contract equals the premiums paid on the life-insurance policy and on the endowment contract, less the dividends received, plus his cost of converting from ordinary life to the endowment contract. Let us assume that these equal $9,000, that this policy matures for $10,000 and that Mr. White has decided that he doesn't want to take this $1,000 gain, even though it can be spread over three years. Therefore, he is interested in the other settlement options which are available.

Life annuities

His first option is the so-called straight-life annuity. This will pay him a stipulated amount per month so long as he lives. Mr. White's life expectancy at 65 is 15 years, and if he lives out this expectancy he will receive $12,150. This amount constitutes his expected return. His contract cost him $9,000, and therefore the cost divided by the expected return equals the percentage of each payment which is a return of principal. This percentage is 74.1% and therefore, of the total annual payments of $810, 74.1% or $600.21 will be principal and the balance of $209.79 reportable as interest. This percentage will remain the same regardless of whether Mr. White lives six or 30 years.

Annuity with ten years certain

The second available option, called a life annuity with ten years certain, is the most commonly selected option. If he selects this option, it is apparent that a portion of what he has paid in is for the promise by the insurance company to pay for this guaranteed period of time. This is in the nature of insurance and, therefore, the 1954 Revenue Code states that Mr. White's cost of the annuity must be decreased by the value of this insurance or refund feature. If Mr. White lives out his life expectancy of 15 years, he will receive $11,088. But whether he lives or dies, the insurance company has guaranteed to pay Mr. White or his beneficiary $7,392. Therefore his cost has to be reduced by a percentage of this guaranteed payment and this percentage is set forth in the Treasury Department's so-called Table III. So reduced and computed, Mr. White's percentage of return of principal is now 71.2% and therefore of the $739.20 annual payment, 71.2% or $526.31 is principal and the balance $212.89 is reportable.

Income with guaranty

A third option is a life income with an installment refund. This means that the amounts guaranteed are paid for life but that if Mr. White dies before he recovers the total amount placed under the option, which is generally the face amount of the policy, the insurance company will continue to pay until this total amount is received. Of course this additional guarantee is another example of a refund feature in the nature of insurance which will reduce Mr. White's cost for the purpose of determining the exclusion ratio. Under this situation, Mr. White's expected return is $10,026 and his cost has to be reduced by the value of the refund feature. Applying the tables, we find that 68.2% of his payments will constitute a return of principal and the balance will be reportable income. Therefore out of a total annual payment of $668.40, 68.2% or $455.85 will be excluded and the balance of $212.55 will be reportable.

Finally, the last available option is

a joint-life-and-survivor annuity. This option guarantees monthly payments for the lives of two people. In other words, it guarantees payments for their combined lives. There is no refund feature under this settlement option, but since the expected period of payment is increased by measuring the life expectancy of two lives, the amount excludable each year will be less. Let us assume that Mr. White's wife is to be the other measuring life and is also 65 years of age. The Government says that a male of 65 and a female of 65 have a combined life expectancy of some 22 years. This results in the expected return on this policy being increased to $12,936. The investment of $9,000 divided by this expected return results in a percentage of principal being 69.6%. Of the annual payment of $588 there is therefore excluded 69.6% or $408.66 and reportable income is $179.34.

In our particular example, Mr. White and/or his beneficiaries will exclude about the same percentage of each payment from Federal taxation regardless of the settlement option selected. However, before selecting a settlement option under an annuity contract, the tax consequences of each option should be computed. ☆

How fancy can you be, or what is "necessary expense"?

WHEN TAX MEN turn philosophical, an interesting speculation is how would a Solomon determine what are truly necessary costs. Is an Oriental rug in the president's office necessary, or should the excess over the cost of ordinary broadloom be disallowed? And if so, what is the cost of ordinary broadloom; is it ten, fifteen, or twenty-five dollars a square yard?

If management is divorced from control, the question probably won't arise. Presumably, the president would rather have a plush office than a bigger salary and higher taxes. But suppose the president is the controlling owner. Is the magnificence then in lieu of nondeductible dividends?

We've heard some talk that the Commissioner is concerned about this problem, that he is worried about the difficulty an agent would have in finding such items. If the firm has a branch in Miami, must the agent determine the man-hours spent at the desk and those spent at the beach? Where is the line to be drawn, and what is to be the measuring rod?

This question recently came before a British court, though the luxury at issue was a Bentley car. Here's how our British contemporary, *Taxation*, reported it in recent issue.

The recent case of *G. H. Chambers (Northiam Farms) Ltd v. Watmough* (17 T.R. 247) once again draws attention to the effect of "personal choice" on the computation of capital allowances in the case of a motorcar. The company, which carried on business as a fruit farmer, purchased a second-hand Bentley car for £6,995. The car was driven only by the managing director of the company, he had voting control and used the car for private purposes as well as those relating to the business. It was agreed that one-twelfth of the total mileage should be regarded as being attributable to the private user.

The General Commissioners [an administrative agency] decided that the capital allowance of £1,749 should be excluded from relief to the extent of £1,020 for personal choice and £146 for personal use. There was thus an allowance of £583. [Of the total cost of £1,749, 1/12 or £146 was excluded for personal use and £1,020 as not necessary; only the balance of £583 is depreciable. *Ed.*] The General Commissioners accepted the fact that it was necessary for the company to have a car for the purposes of its business but they thought that the purchase of the Bentley car was dictated in part by the consideration of the personal choice of the managing director. They considered that the Bentley was not a car of the kind which would have been bought had its purchase been dictated by consideration of the requirements of the company's business alone.

The company maintained before the Commissioners that the choice of the Bentley was not unreasonable and that the capital allowance should be abated only by the sum of £146 for private running. The Crown argued that "personal choice" was a relevant circumstance to be taken into account for the purpose of deciding a just and reasonable allowance.

On appeal from the Commissioner's decision, Mr. Justice Vaisey said that he could not come to the conclusion that the General Commissioners had had regarding circumstances that were not relevant. The learned judge went on to say that he thought it would be unreasonable to buy a Bentley at a cost of £7,000 for the purposes of the trade of a fruit farmer. He said that the expression "personal choice" was a curious one, but it meant that the car would not have been bought by anyone who, in considering the question of its purchase, was directing his mind solely and exclusively to the necessities of the trader or of the trade as such.

Mr. Justice Vaisey said that there was ample evidence of the element of personal choice. Mr. Justice Vaisey said that whether the General Commissioners gave rather a high figure or rather a low figure in the amount they fixed in relation to personal choice, he did not know, but he said, "I do not myself regard it as in any way unreasonable."

Taxes make people do crazy things

ALL WE KNOW of the Broadway hit *My Fair Lady* is what we hear around, having neither influence nor $100 with which to get tickets. But even at this distance we do hear of a tax maneuver by one of the big wheels in the deal. It sounds crazy when you first hear about it, but as with so many things affected by taxes, it turns out to be crazy like a fox when you think it through.

Why should Herman Levin, the producer, sell any part of his 30% interest in what is probably the biggest hit of all time, and probably also the biggest money-maker? Taxes.

Guessers say he might have taken $1.5 million out of the show from his 30% interest. But instead of holding on and getting ordinary income, he sold two-thirds of his interest for $450,000. His capital gain tax was $112,500, his net after taxes $337,500. If he had held on, getting the $1 million over five years at ordinary income rates he would have ended up with about $250,000 after taxes. ☆

New decisions

Payments were for child support, not alimony. Payment of some $600 received by taxpayer from her divorced husband were, the court finds for arrearages of child-support payments, not for alimony. The payments were made pursuant to an oral agreement under which taxpayer agreed to withdraw a warrant of arrest against her former husband for

failure to support the children. *Brockel,* TCM 1956-243.

Alimony deductible though not taxable to nonresident wife. A citizen and resident of Puerto Rico employed by a U. S. agency may deduct alimony payments to his former wife even though she may exclude such payments from her gross income because she is a citizen and resident of Puerto Rico. *Rev. Rul.* 56-585.

Joint return allowed before divorce decree becomes final. An interlocutory divorce decree obtained by taxpayer's wife in 1950 did not become final until 1951. A joint return for 1950 is allowed. *Ostler,* CA-9, 10/5/56.

Foster mother not a dependent. A foster mother who acted as a parent to taxpayer, though there was no relationship by blood, marriage or adoption, does not come within the definition of a "dependent." [Under 1954 Code, relationship is not required if person supported is a member of taxpayer's household. *Ed.*] *Frank,* TCM 1956-236.

Divorced parent denied dependency credit for child. Taxpayer-father is denied a dependency credit for his child who was in the custody of his divorced wife. He was unable to prove that his contributions of $350 were more than one-half the child's support. *White,* TCM 1956-264.

Husband receiving partnership earnings not incapable of self-support. Although child-care expense must be reduced by the amount the joint adjusted gross income exceeds $4,500, this limitation does not apply if the husband is incapable of self-support. The IRS holds that a husband who receives income from a joint venture or partnership in which his personal services were an income-producing factor is not "incapable of self support," even though he became ill and his wife had to complete his work. *Rev. Rul.* 56-612.

Bookmaker's expenses disallowed as illegal; payouts held overstated. A partnership operating a bookmaking business is denied deduction of rent and wages paid. Such payments violated clearly defined state public policy. Deductions claimed for payouts to winning bettors are disallowed in part because the partnership failed to make satisfactory explanations for erasures in the footing figures on a great many betting sheets. *English,* TCM 1956-254.

Cost of African safari deductible by a dairy corporation. [*Acquiescence*] The cost of a big-game hunt by a husband and wife, corporate officers of taxpayer dairy, was held to be an ordinary and necessary expense of the dairy. Films taken on the hunt were exploited successfully as advertising, and trophies were set up at the plant in a game museum open to the public. The fact that the officers enjoyed the hunt does not make such work a mere hobby, or the cost of the trip income to the hunters. *Sanitary Farms Dairy,* 25 TC 463, *acq.* IRB 1956-47.

Don't count on deducting African safari. The holding in Sanitary Farms Dairy (25 TC 463 *acq.* IRB 1956-47) that the cost of an African safari may constitute a deductible advertising expense will be strictly construed and applied only to cases of substantially identical facts. *Rev. Rul.* 56-583.

Can't deduct salary payments to state official. As a dealer in hospital supplies and equipment, taxpayer hired Moore at $500 per month as "hospital consultant." Moore was State Director of the Division of Hospitals and a part of his official duties was to check the plans and specifications for merchandise and equipment for state hospitals. The court disallows the payments to Moore as contrary to public policy; his employment by taxpayer and the services rendered by him were antagonistic to and in conflict with his duties and responsibilities as a public official. *Stover Co.,* 27 TC No. 48.

Attorney can deduct travel to PLI tax lectures. The cost of travel to New York, hotel expenses in New York for the two-week period of the Practicing Law Institute tax course, and expenditures for tuition and books (a total of about $450) are allowed to the taxpayer, an attorney. The attorney also attended the Lions Convention while in New York, *Bistline,* DC Idaho, 11/1/56.

Jury allows higher amount for travel and entertaining expenses. The jury found from the evidence that the expense for 1947 was $8,937.02, and in 1948 was $12,672.16 more than had been allowed by the Commissioner. *Mohr,* DC Va., 9/24/56.

New Mexico cigarette tax not deductible. The New Mexico cigarette stamp tax effective July 1, 1955 is not a retail sales tax imposed on persons selling tangible personal property at retail and is therefore not deductible by the consumer. *Rev. Rul.* 56-598.

Costs of investigating and searching for a business not deductible. Having been an employee of a Pontiac agency, taxpayer started negotiations for the acquisition of an auto agency in his own name. Travel, meals, lodging and telephone expenses incurred in connection with unsuccessful efforts to locate an agency are not deductible either as a business expense (he was not yet in business) or as a loss incurred in a transaction entered into for profit (he was only looking for transactions). *Day,* TCM 1956-253.

Part of community income taxable to wife in year of divorce. Taxpayer and her husband were domiciled in Texas, a community-property state. They separated in April 1946 and were divorced in December 1949. Because they were married for 11 months during 1949, the wife is held taxable on 11/12 of one-half of the husband's 1949 business income. In the absence of an agreement, prior to the divorce, dissolving the community of property, this was her community income. *Douglas,* 27 TC No. 32.

Business income is part community and part separate income. Capital in the business was separate property. The court finds that interest, at 8%, on that capital is separate income; the balance was salary for the husband's services, that is, community income. *Karpe,* DC Calif., 10/11/56.

Liquid entertainment not deductible in a dry state. Whisky purchased in Oklahoma for business entertainment and the promotion of goodwill cannot be deducted as an ordinary and necessary business expense because state law made it illegal to traffic in intoxicating liquor. *Finley,* 27 TC No. 46.

Collapse of motor in 11-year old auto not a casualty loss. Damage to the motor of an 11-year-old car resulting from the breakage of the oil line and escape of all the oil was not a casualty loss. The damage was the result of progressive deterioration rather than the invasion of some hostile force. *Rice,* TCM 1956-258.

Cannot apply deficiency payments to defeat penalty for tax underestimation. In determining whether 80% of total tax liability for a given year was paid on account of estimated tax for purposes of the underestimation penalty, taxpayer is not permitted to aggregate with the estimated tax payments amounts paid during the year for prior years' deficiencies. *Hays Estate,* 27 TC No. 37.

Penalty for both failure to file and underestimation denied. The court follows district court decisions in Georgia and Nebraska. It concludes that since the 10% penalty imposed under the 1939 Code for nonfiling is greater than the 6% penalty for substantial underestimation, only the 10% penalty is applicable. [The Commissioner has announced that he will not follow the Georgia case (*Ridley,* 120 F Supp 530) *Ed.*] *Powell,* DC Oreg., 11/13/56.

Bus route was temporary assignment; travel expenses allowed. For several years prior to 1952, taxpayer was employed by the Post Office Department as a clerk in Greenville, S. C. where he and his wife lived, and where his wife was employed. Effectve November 1, 1951, he was assigned to drive a bus from Columbia to Greenville and back. He had no definite understanding on how long the assignment would last. On such runs he was required to remain in Columbia overnight. Effective August 1, 1952, he was reassigned to Greenville. The court holds the Columbia-Greenville route was a "temporary" assignment; the amounts expended by taxpayer in Greenville for food and lodging were therefore deductible as away-from-home travel expenses. *Rice,* TCM 1956-258.

Heart patient can deduct cost of home elevator. On the advice of his doctor, taxpayer installed an elevator at a cost of $2,000 in the apartment house in which he rented an apartment. The lease would permit him to remove the elevator, a simple one which could easily be removed. The court withholds discussion of other cases and holds that the cost was part of treatment, mitigation or prevention of reoccurrence of an illness. *Post,* DC Ala., 10/15/56.

Elevator for elderly arthritic a medical expense. Taxpayer, aged 71 and suffering from arthritis, installed an "invalid-elevator" in her home, at a cost of $1.880. The court holds that the elevator was not a capital improvement; it is a medical expense. It was installed to mitigate the aggravation of the arthritic condition. *Snellings,* DC Va., 10/8/56.

NEW DECISIONS IN FRAUD & NEGLIGENCE THIS MONTH

Court won't order attorney to disclose client's business. Alleging that an attorney was merely a collection agency in connection with an examination of a doctor-taxpayer's returns, the Government sought to obtain taxpayer's records from the attorney. The court finds that the doctor had been the attorney's client, that the attorney had possession of the records in a professional capacity and that such possession was privileged. *Schwarz,* DC, DC 8/4/56.

Fraud not established; net-worth schedule unreliable. Taxpayer asks for refunds of taxes and fraud penalties which the Commissioner assessed for 1941-1949. The court finds that the Government's net-worth schedules are unreliable because they reflected no opening cash balance, though taxpayer had for many years conducted his business with cash. Taxpayer was not guilty of fraud. To the extent that the statute of limitations, in the absence of fraud, applied, taxpayer also recovers the additional taxes assessed. For the years, 1947-1949, the additional assessments are allowed to stand, since apart from the issue of fraud, taxpayer had the burden, which he did not meet, of proving that the Commissioner erred. *Mercer,* DC Mont., 10/4/56.

Fraud penalties were improper. After the three-year statute of limitations expired and after the taxpayer died, the Commissioner assessed taxes and fraud penalties for 1945-1948. On the suit for refund, the Government had the burden of proof in the fraud issue. The court finds that the proof of fraud is insufficient. Taxpayer operated a small Georgia farm. He and his wife had limited education, and they employed a local attorney to prepare their returns. They had no intention of evading tax. The Government's computation contained many errors. *Langford,* DC Ga., 11/7/56.

Bank deposit and expenditure methods warranted; books were inadequate. Taxpayer's books did not reflect income from gambling operations. The evidence is sufficient to sustain the Tax Court's finding that income was understated and that certain deposits were income not loans. *Traum,* CA-7, 10/12/56.

Court refuses to accept existence of cash hoard of $45,000. Taxpayer-grocer admitted the general correctness of the Commissioner's net-worth statements but alleged that he had undeposited cash of $45,000 at the beginning of the net-worth period which was not considered in the calculations. The court concludes he had no more than $7,500 of undeposited cash at that time. Fraud penalties are upheld. *Samkoff,* TCM 1956-251.

Druggist's income reconstructed from net worth. The Commissioner is held justified in using the net-worth method to reconstruct the income of a drug-store operator whose books were inadequate. The druggist failed to convince the court that a hoard of cash hidden in a trunk could explain the discrepancy in the amount determined and that reflected on his books. Penalties for negligence, failure to file declarations of estimated tax, and substantial underestimation are sustained. *Wheeler,* TCM 1956-244.

Records destroyed; Commissioner has choice of income-computing method. Taxpayer operated a beer parlor, lunch counter, and pool hall. As his records for 1943-1946 had been destroyed (in good faith), the revenue agent recomputed income on the basis of bank deposits. Taxpayer contested the deficiency assessment, claiming this method greatly inflated income. He engaged his own CPA to recompute income by net-worth computations. The Tax Court held that the choice of methods, where no books are kept, rests with the Commissioner. This court approves the Tax Court's action in estimating 1943-1946 expenses from 1947 disbursements; it was best that could be done. *Miller,* CA-5, 11/2/56.

Procedure in tax-evasion trial held valid. Taxpayer based his appeal on the introduction at the trial of testimony about his gross receipts and net income. This

evidence was properly admitted, the circuit court finds on review. It also finds that the instruction of the trial judge about willful tax evasion (knowingly filing a false return with the intention of evading or defeating the tax due) was adequate. The trial judge did not commit error either, the circuit court says, when he instructed the jury about a felony only and gave no instructions about possible lesser conviction for misdemeanor. *Lee,* CA-9, 10/24/56.

EPT fraud penalty computed after credit for income tax. Taxpayer filed fraudulent excess profits tax returns for 1943, 1944 and 1945. The fraud consisted of overaccruing salesmen's commissions and of omitting sales from income. The Government computed the fraud penalty on the excess profits tax deficiency. However, the higher excess profits tax resulted in an overpayment of income taxes. The court holds this should be deducted from the deficiency before the penalty is computed. However, for the purpose of computing the 1943 penalty, the court refuses to allow the postwar refund credit. *Jacobs Brothers, Inc.,* Ct. Cls., 11/7/56.

Net worth applied even though apparently accurate records were kept. The net-worth test is held properly applied to taxpayer, a well-known attorney, even though his books and records were accurate and adequate on their face. His yearly net-worth increases did not appear to be consistent with the income which had been reported in his returns. The court holds the use of the net-worth method as a check on the books was proper. Taxpayer explained that the apparent discrepancy was accounted for by loans of $54,000 from his mother-in-law and the exhaustion of a $30,000 cash hoard at the beginning of the period. The court, after giving taxpayer the benefit of his claim for beginning net worth and for borrowings, finds no deficiencies for six out of the nine years in issue. Deficiencies are determined for the last three years. But having been favorably impressed with taxpayer's credibility and sincerity, the court refuses to find any fraudulent intent. *Berke,* TCM 1956-259.

Net worth adjusted for cash hoard in garbage can. Taxpayer admitted the correctness of all items on the Commissioner's net-worth statement except the existence and amount of cash on hand. He contended that he had saved up and hidden away $42,000 in a buried garbage can. The Commissioner allowed $1,000, while the court, applying the *Cohan* rule, found as a fact that taxpayer had hidden away $24,000 in the receptacle. Part of the deficiencies for each of the years was held due to fraud. *Galant,* 26 TC No. 43, *acq.* IRB 1956-46.

Fraud penalty upheld; taxpayer though uneducated was too shrewd to make large errors innocently. Taxpayer, the owner of a retail-jewelry business conceded that large unexplained deposits represented unreported income but argued that their omission was due to his lack of education and to poorly trained and poorly supervised help employed during the war years. The court however notes that taxpayer was intelligent enough to conduct successfully several retail-jewelry stores in a highly competitive field, and it upholds the fraud penalty. *Bernstein Estate,* TCM 1956-260.

Jewelers' income reconstructed by gross profit markup. In determining whether decedent understated his taxable income from a retail-jewelry business which did not maintain accurate records, the Commissioner determined net income by using the normal markup on purchases. The court holds this method was proper; the Commissioner was not limited to the use of the net-worth method. He was free to reconstruct income by any method that would properly reflect income. Concerning the normal markup, the court, noting testimony that taxpayer continuously undersold his competitors, reduces the markup percentage used by the Commissioner from 45 to 37½%. *Bernstein Estate,* TCM 1956-260.

No fraud penalty for honest attempt to correct underestimate. Having conducted business for several years under various fictitious names and having failed to record many of its sales, a partnership hired a reputable accounting firm in the middle of 1945 to determine all omitted sales so that the partnership could make a voluntary disclosure of the unreported income to the Treasury. The accountants determined that sales of $295,000 had been omitted in 1945; they included these sales in the 1945 partnership return. The Commissioner contended that $101,000 additional sales remained unreported for 1945. The court agrees. But it refuses to approve a fraud penalty; there was an earnest and conscientious attempt by the partners, acting through their accountants, to prepare an honest return for the taxable year. *Cohen,* 27 TC No. 22.

Government failed to prove income from overceiling prices. A partnership which sold used cars to an auto-sales agency reported as income during 1946 and 1947 the total of the invoice prices of such cars. Based upon a partial check of some of the records of the auto-sales agency, the Commissioner alleged the partnership sold the used cars at prices in excess of OPA ceilings and pocketed the difference. Highly critical of the Government's handling of the case, the court holds the partnership's burden of disproving the existence of any deficiencies was amply sustained by the evidence. *Boettcher,* TCM 1956-267.

Government has burden of proof on issue of fraud. Taxpayer brought suit in the district court for recovery of an assessment which included a fraud penalty. The court rules that the Government must plead the alleged fraud and has the burden of proof with respect thereto. *Trainer,* DC Pa., 11/7/56.

Jury finds reasonable cause for failure to file. Taxpayer testified that upon inquiry he was told by a revenue agent that he did not have to file a return because he did not know in advance what his tax liability would be. The Government contended that the taxpayer's alleged conversation took place in 1944 or 1945 and that the taxes here involved were for the years 1951 and 1952. The jury returns a verdict for the taxpayer. *Carmichael,* DC Ga., 10/5/56.

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Final Regs. clarify rules on distributions under pension and profit-sharing plans

by **JOHN A. CARDON**

The final Regulations draw sharper distinctions between pension and profit-sharing plans, allow pension plans to include disability payments, recognize incidental layoff benefits, solidify rules on integration with social security, discard the necessity of a formula, and shed further light on what distributions are taxable at capital gain rates. Mr. Cardon points out the significance of these changes, and in doing so he draws a composite picture intended to be stimulating to the expert and helpful to the novice in this field.

RECENTLY the final Regulations under Sections 401-404 were issued and, in spite of the fact that there were only minor changes in the law from the 1939 Code, there are some new aspects to be considered in determining the method an employer should choose in setting up a retirement program.

In the past, many employers chose not to assume the fixed obligation inherent in a pension plan and chose instead a profit-sharing plan. Although a payment to the plan was required only in profit years, the employer had no discretion as to the amount of the contribution, for the Commissioner required that the plan contains a fixed formula for this purpose.[1]

To employers in such a situation, the profit-sharing device is even more attractive now. The final Regulations under Section 401(a) no longer require a definite formula for computing employer contributions, although they still call for a definite formula for allocating the contributions to the participants. Thus, the employer may control the cost of a profit-sharing plan to a much greater extent than before. It is true that the Regulations prohibit contributions "at such times or in such amounts that the plan in operation discriminates" in favor of the officers, the higher paid, or the supervisory employees[2] but compliance with this should not be difficult.

The Regulations also require that the plan be permanent; in this connection, they state that: "it is not necessary that the employer contribute every year or that he contribute the same amount or contribute in accordance with the same ratio every year. However, merely making a single or occasional contribution out of profits for employees does not establish a plan of profitsharing. To be a profitsharing plan there must be re curring and substantial contributions out of profits for the employees."[3]

Ironically, this outlaws the "one-shot" type of profit-sharing plan which was involved in the *Lincoln Electric Co.* case[4] which started the litigation on the point and ultimately caused the Commissioner to abandon his prior rule.

The new Regulations may well result in more litigation than the old in order to settle such indefinite terms as "occasional," "recurring," and "substantial" when applied to employer contributions. What is "occasional" and what is "recurring" would seem to depend upon the profit experience of the particular employer. It is conceivable that a single contribution in a profit year succeeded by loss years would not prevent a plan from qualifving under Section 401(a) in spite of the Regulations.

Two observations on the discretionary formula must be noted: First, the amount to be contributed must be accrued before the close of the year if the employer is to take a deduction. This means profits must be fairly well known so management can act to fix a liability before the year's end.[5] Second, from the employee's standpoint, the absence of a definite formula may not instill in the employees the confidence often necessary to the successful operation of a profit-sharing plan.

Incidental benefits

The new Regulations draw a sharper distinction between pension and profit-sharing plans on the basis of benefits provided. This may be important to the employer who wishes to combine certain other benefits with a plan for retirement benefits.

Under the new Regulations, a qualified pension plan may contain a disability pension and a death benefit, but "benefits not customarily included in a pension plan, such os layoff benefits or benefits for sickness, accident, hospitalization, or medical expenses" are outlawed.[6] On the other hand, a profit-sharing plan is not so restricted. The new Regulations specifically recognize incidental layoff benefits (although such benefits have been provided by some profit-sharing plans for a number of years) and also permit the use of amounts allocated to the participant's account to purchase "incidental life or accident or health insurance."[7]

Integration

The amount of retirement income which may be provided by the employer is limited if the plan, whether a pension or a profit-sharing plan, provides greater benefits on compensation above the social security wage base than on the compensation below. The detailed formula for achieving "integration" has heretofore been spelled out in Mimeographs 5539 and 6641 and, as a social security coverage and benefits have increased over the years, the percentage of benefits allowed from employer contributions has also increased. We seem to have reached a plateau, however, for the new Regulations retain the old ceiling applicable when the Federal law covered only the first $3,600 of annual

[1] Regs. 118, Sec. 39.165-1(a)(2).
[2] Sec. 1.401-1(b)(1)(ii).
[3] Sec. 1.401-1(b)(2).
[4] 190 F.2d 326 (6th Cir. 1951).
[5] See Rev. Rul. 56-366, IRB 1956-31.
[6] Sec. 1.401-1(b)(1)(i).
[7] Sec. 1.401-1(b)(1)(ii).

compensation. Thus, the maximum benefit remains at 37½% of average compensation in excess of $4,200 over the highest five-year period on the basis of a life annuity at 65 after 15 years of service. This is on the basis of death benefits before retirement and an actuarial reduction of the pension payable in case of early retirement.

Under Mimeograph 6641 profit-sharing plans were integrated by limiting the amount of contributions on behalf of an employee to 9⅜% of his covered compensation, and the rule should still be good.

How about a combination of pension and profit-sharing plans involving integration? The Regulations permit splitting the allowable benefit between pension and profit-sharing if the plans do not cover the same compensation, for instance, a past-service pension plan and a future-service profit-sharing plan. Otherwise, the rule of Paragraph 19 of Mimeograph 6641 seems to be in effect so that if the employer has a pension plan *involving* integration, he may not add a profit-sharing plan on top of it to supplement the same compensation regardless of how little of the integration margin is taken up by the pension plan. (The Regulations are not as clear as they might be on this point and should be clarified. Integration with social security is admittedly difficult under such circumstances, but it would seem that if a way can be figured out to integrate, the IRS should permit it.)

The inclusion of this principle in the Regulations is new and adds dignity to the rule which it did not have as long as it was in Mimeograph form. Had it been in the proposed Regulations, it would doubtless have caused much comment, for there has never been a public hearing on the point.

Cash vs. deferred distribution

In recent years, there has been an increased interest in profit-sharing plans which permit the employee to elect in advance either to participate in a cash distribution or to have his share set aside in a qualified trust for payment later. In determining if the plan meets the requirements of Section 401(a) of the Code, the issue has been whether or not to consider employees who participate solely in a cash distribution.

The matter has been resolved in the new Regulations by excluding from consideration all employees who receive their share of the profit in cash. This rule is to be followed in deciding the coverage[8] and whether or not the benefits discriminate in favor of the highly paid and supervisory employees.[9] The rationale of the Commissioner's position is that Section 401(a) relates only to deferred plans and that a plan cannot qualify under this section unless it provides for an accumulation of the profit share for a fixed number of years, the attainment of a certain age or the occurrence of a certain event.

The net result is that these "combination plans" may or may not be acceptable. If the employer desires to install one, he will have to make the deferred portion attractive to a wide group of employees so that enough of them will elect to participate in that portion to meet the coverage requirements of the statute. As a rule of thumb, the Commissioner has indicated that if 50% of the covered employees fall in the lower two-thirds based on compensation, the coverage is adequate.[10]

Distributions at death or termination

Under Sections 402 and 403 of the 1954 Code, the participant in a qualified plan incurs no tax until benefits are paid or made available, at which time they are taxable as annuities under Section 72 of the Code. If the plan is contributory, an exclusion is allowed with respect to each payment in an attempt to spread the employee's cost over the period of payment. The computations required by Section 72 are rather complicated, and there is nothing much the employer can do about it except to see that adequate records are kept and perhaps condition the employees for the rigors of Section 72 because the shock of the tax treatment thereunder may be as great as the change to retirement.

Under the 1954 Code, distributions of the total amount payable from a qualified plan or trust on account of the termination of the employee's services or on account of death after retirement are taxable at capital gain rates. The new Regulations shed further light on what payments will be considered within the scope of this rule. Thus, capital gain results if the employee is paid everything in his account in a profit-sharing trust upon termination of employment even though he will receive an additional payment in the following year based on profits for the year of termination.[11] Surrender of an annuity contract for its commuted value by a retired employee after receipt of annuity payments under it will not result in capital gain.[12] The new Regulations should be carefully examined when the employer is considering methods of distributing benefits on termination of service or death after retirement.

Death benefits

A death benefit is one of the oldest forms of fringe benefit. For large groups of employees, it is most often provided under group-term life-insurance contracts, the tax consequences of which are clear: The employer is entitled to deduct its cost as an ordinary and necessary business expense, there is no tax on the employee for the cost of the protection, and the proceeds are excluded from the beneficiary's income. The tax advantage for the employee is lost, however, if a group-term contract is part of a qualified pension trust for then the cost of the insurance paid by the trustee is considered a distribution from the trust and currently taxable to the employee.[13] Group-term insurance may be combined with an annuity plan without losing the tax advantage to the employee, provided no trust is involved and the annuity and insurance portions of the contract are clearly separated.[13a]

Death benefits may, however, be provided under a qualified pension or profit sharing plan without adversely affecting the tax status of the plan. This is true whether the benefit is insured or noninsured.

If a qualified plan provides a death benefit, the tax consequence to the employee and his beneficiary depends upon whether the benefit is insured or noninsured.

Noninsured benefit

There is, of course, no tax on the employee at the time the employer's contribution is made in the case of nonsinured death benefits. The benefit is merely the accumulation necessary to provide the retirement income if a pension plan, or the aggregate of the amount in his account if a profit-sharing plan.

When the benefit is paid, a tax lia-

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[8] Sec. 1.401-3(e).
[9] Sec. 1.401.4(a)(1)(ii).
[10] Rev. Rul. 56-497, IRB 1956-41.
[11] Sec. 1.402(a)-1(6)(ii).
[12] Sec. 1.402(a)-1(6)(iii).
[13] Rev. Rul. 54-52, IRB 1954-2.

bility arises but the impact of the tax can be controlled to a large extent by the way in which it is paid. Thus, if a qualified plan provides for a lump-sum distribution upon the death of the employee, the payment is excludable from the beneficiary's gross income to the extent of $5,000 by virtue of Section 101(b) of the 1954 Code. If the payment exceeds that amount, the balance is subject to tax at capital gain rates by virtue of Section 402(a)(2) of the Code.

On the other hand, if the payment is made in installments, the availability of the exclusion depends upon the nature of the employee's rights, the exclusion being applicable only to the extent the employee's rights immediately prior to his death were forfeitable. The installment payments would, of course, be taxable as annuities under Section 72 and, if there is any exclusion under Section 101(b), it is added to the employee's cost in applying the rules of Section 72. Since most qualified plans proide for graduated vesting, the exclusion under Section 101(b) vanishes after the employee has completed the vesting period if the benefit is paid in installments.

It is obvious that the right of the committee administering a plan to prescribe various alternative forms of payment is of utmost importance in order to minimize taxes and conserve the death benefit for the employee's beneficiary.

The estate tax consequences should not be overlooked. Section 2039(c) of the 1954 Code excludes from the decedent's gross estate annuities or other payments by a qualified plan or trust to the employee's beneficiary (other than the executor) which are attributable to the employer's contributions. Although the statutory language is broad and clear the Regulations recently proposed under Section 2039(c) drastically limit the exemption, particularly in the case of profit-sharing plans. The proposed rules come as a shock and raise considerable doubt as to the status of many death-benefit payments heretofore considered clearly excludable from the decedent's gross estate. The proposed Regulations hardly seem warranted by the statutory language and it is hoped that the final Regulations will be considerably revised.

As if the proposed estate tax Regulations were not enough, the Internal Revenue Service recently handed another setback to those who looked upon the qualified employee trust as a means of minimizing both the income and estate taxes. Shortly after Section 2039(c) was enacted, it was proposed by some planners in this field that where the employee does not need income at retirement the plan should be flexible enough to permit him to postpone payment of all or part of his benefit until his death and then have it paid to his beneficiary. The use of this device has been effectively blocked by a recent ruling that a plan will not meet the requirements of Section 401(a) if it permits the employee to elect irrevocably to have all or a part of his nonforfeitable interest in a profit sharing trust paid only to his beneficiary.[13b] Many individuals who may have felt justified in taking a chance under the estate tax law will not feel justified in running the risk of having the plan disqualified by the use of such an option.

Insured benefit

Pensions are sometimes provided under individual retirement-income or endowment policies or, as is more often the case, under group permament-insurance contracts, all of which carry life-insurance protection before retirement. The contract consists of an annuity reserve which builds up over the years and a life-insurance feature which declines as the annuity reserve is built up. This type of death benefit presents a more complicated tax picture.

First, the employee is currently taxable on that part of the employer's contribution which purchases the insurance protection, the cost being figured at low rates. This has been true for a number of years and the new Regulations continue the practice.[14]

Second, when the contract is distributed to the employee, he must within 60 days irrevocably convert the life-insurance feature to annuity or be taxed on the *entire* cash value—i.e., the value of the annuity element plus the value of the insurance element.[15] This represents a reversal of the rule applicable before the new Regulations became final, in spite of there being no change in the statute for 14 years.

Third, if the employee dies before reaching retirement age, the proceeds paid to his beneficiary are viewed for income tax purposes as consisting of two parts, an annuity element and an insurance element. The latter is excludable under Section 101(a) of the Code while the former is excludable to the extent it meets the requirements of Section 101(b).

Fourth, for estate tax purposes the proposed Regulations state the entire proceeds will be included in the employee's gross estate if death occurs before the terminal-reserve value of the contract equals the death benefit. In such a case, the contract is considered one of life insurance and taxable under Section 2042 o fthe Code.[16] This is inconsistent with the treatment of the proceeds for income tax purposes and was the subject of considerable comment at the hearings on the proposed rules.

Accident and health plans

In addition to providing pensions and death benefits, the employer may proide for emergencies during the course of employment, such as accident or sickness of an employee. The 1954 Code and the recent pension and profit-sharing Regulations contain provisions which should be kept in mind in planning for such contingencies.

Section 22(b)(5) of the 1939 Code excluded from income amounts received through accident or health insurance as compensation for personal injuries or sickness. Although the Commissioner generally required the presence of an insurance contract as a prerequisite to the exclusion, the courts often disagreed.[17] Section 105 of the 1954 Code was intended to remove the distinction between insured plans and those under which benefits are paid directly from the employer or from a trust.

In marked contrast to the requirements for qualifying a plan under Section 401,

[13a] Rev. Rul. 56-633, IRB 1956-50.
[13b] Rev. Rul. 56-656, IRB 1956-51.
[14] Sec. 1.402(a)-1(a)(3).
[15] Sec. 1.402(a)-1(a)(2).
[16] Sec. 20.2039-1(d).
[17] Epmeier v. United States, 199 F. 2d 508.
[18] See proposed Regulations 1.162-10(a).
[19] Sec. 1.105-4(a)(3)(i).
[20] Sec. 1.402(a)-1(a).
[21] Sec. 1.105-4(a)(2)(ii).

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the employer has wide latitude as to the type of plan he may install under Section 105. The word "plan" is defined in the Regulations to mean "an arrangement for the payment of amounts to employees in the event of personal injuries or sickness." There are no requirements as to the classes or number of employees that must be covered. In fact, the plan may cover only one employee. It need not be reduced to writing but may consist of a program, policy or custom having the effect of a plan. The plan may be insured with an insurance company; it may be funded by means of a self-insured trust; or the employer may finance the plan by current "out-of-pocket" disbursements.

The tax consequences of these plans are even more favorable than plans under Section 401(a). The employer may deduct the cost of such a plan without all of the detailed information necessary to sustain a deduction under Section 404 with respect to qualified plans.[18] Section 106 excludes from the employee's gross income contributions by the employer to accident or health plans, whether insured or self-insured. Benefit payments from such a plan are *tax-free* to the employee, if they are reimbursements for medical expenses (not attributable to deduction in prior years), payments for bodily injury or disfigurement or payments of wages or in lieu of wages not in excess of $100 per week. If the plan is contributory, the amount attributable to the employee's contributions is excludable under Section 104.

Disability benefits under qualified plans

Immediately upon the enactment of Section 105 the question arose about the relationship between it and Sections 402 and 403, for many qualified pension and profit-sharing plans carry a disability benefit payable upon total and permanent disability prior to retirement.

The Treasury's interpretations have been quite liberal. The Regulations under Section 105(d) were written to bring within the exclusion of that section permanent disability benefits paid before but not after the employee reaches "retirement age."[19] To be consistent, it was obvious that the Regulations under Section 402 had to provide that payments from a qualified plan may be excludable from gross income under Section 105(d) and they so provide.[20]

Some question has been raised concerning the meaning of "retirement age" as used in the Section 105 Regulations. Is it the age at which the employee must retire, the normal retirement age, or any earlier age at which the employee may retire under the plan? It is submitted that this question is not a real obstacle. Most retirement plans specify an age (usually 65) at which the employee will *normally* retire with the *normal amount* of retirement benefit contemplated by the plan. The Regulations under Section 105 should be construed in light of this common practice.

Some qualified pension plans do not provide a disability benefit as such but do permit an employee to retire on a reduced pension if he has reached age 55 and has been employed for a given number of years. If an employee becomes disabled and elects to retire under an early retirement option, the payments are in fact due to personal injury or sickness and should be excludable under the following provision of the Regulations:[21]

"Thus, if an employer has a plan for continuing the wages of employees when they are absent from work, regardless of the cause of the absence from work, section 105(d) is applicable to any payments made under this plan to an employee whose absence from work is in fact due to personal injury or sickness."

Here, again, the importance of flexibility of payment must be noted. In some profit-sharing plans a lump-sum distribution is provided in case of permanent disability. If payment is made in this manner, the exclusion under Section 105(d) of the Code is not fully utilized. Whether a lump-sum payment is to the employee's advantage is also questionable.

Other types of benefits may be paid from a Section 401(a) plan. Conceivably, a profit-sharing plan might provide reimbursement for medical expenses such as those contemplated in Section 105(b). If so, the question is whether Section 105(b) is available. Regulations under Section 402 refer only to paragraph (d) of Section 105, but it would seem only logical that if the exclusion of Section 105 supersedes the language of Section 402 with respect to one type of benefit within Section 105, it also supersedes it with respect to any other benefit mentioned there. However, the Regulations do not go this far, and in planning a profit-sharing trust with such benefits the employer would be well advised to obtain a ruling on the point.

New compensation decisions this month

IRS limits exclusion of annuity for pre-1925 service. In *Rev. Rul.* 56-125, the Service held that distributions under an employees' funded annuity plan, on account of the employer's contributions to the fund for his services rendered outside the U. S. were income from foreign sources. The Service now limits this exclusion to payments on account of the employer's contributions prior to 1925, when the exclusion of income earned abroad was first put in the law. The new rules on taxation of annuities apply to years after 1954. *Rev. Rul.* 56-571.

Annuity plan with separate group-term and health insurance may qualify. An employees' annuity plan is funded by a contract with an insurance company which contains, in addition to the retirement-annuity benefits, provisions for separate group-term life insurance and for accident-and-health insurance. Despite these additional benefits, which are not permitted in qualified plans, the plan may be a qualified plan with respect to the annuity portion of the contract. Premiums paid for the insurance and health benefits may be deductible as ordinary and necessary business expenses. *Rev. Rul.* 56-633.

Suspension of pension-plan contributions will not affect qualification. Qualification of a pension or annuity plan will not be lost by the suspension of employer contributions if the employee benefits are not affected by the suspension, and if the unfunded past-service cost at any time does not exceed such cost as of the date of establishment of the plan. However, the plan must provide for granting, at the time of suspension, full vested rights similar to rights arising on actual termination. *Rev. Rul.* 56-596.

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Agran case: California CPAs explain why they did not appeal to Supreme Court

CONSIDERING that some accountants felt strongly that the *Agran* case was so important to the right of nonlawyers to practice before the Treasury Department that it should certainly have been appealed to the U. S. Supreme Court, it is of unusual interest now to have detailed explanation of the California Society of CPAs as to how it reached its decision not to carry forward the appeal. [See also 6 JTAX 42].

The Society has recently sent to its members a bulletin explaining its conclusion. The extensive nature of the Society's study of this question is impressive, as is the array of legal talent consulted.

Because of the likelihood of future reference to this case, practitioners in other states will undoubtedly find beneficial the text of the Society's report. It is quoted below.

To the Members

In a regularly convened meeting of the Board of Directors of The California Society of Certified Public Accountants held at the Statler Hotel in Los Angeles on Monday, November 5, the Board voted by a substantial majority not to participate in any efforts to have the *Agran* case reviewed by the United States Supreme Court. In addition to the officers, directors, chapter presidents and secretaries, members of the Committee on Relations with the Bar, and members of the Committee on Taxation were invited to participate. The decision followed many hours of discussion and everyone present was given an opportunity to make a statement.

The Board meeting was set to follow immediately the return of President Rudolph E. Lindquist and Vice-President Malcolm M. Devore from an eight-day trip to the East where they visited the people set forth in the footnote* and sought their views on the Agran matter.

President Lindquist and Vice-President Devore reported to the Board in considerable detail over a period of several hours the varying and widely divergent opinions offered by these people and by counsel for our State Society, Frank G. Stapleton of Loeb and Loeb, with respect to the many aspects of the Agran case. The basic question which confronted the Board, which was agreed to by everyone present, was that the course of action to be pursued should be that which would best protect the rights of certified public accountants, particularly in California, to continue serving their clients on tax matters on much the same basis as they have been doing for over 40 years. A minority believed that the best way to protect these rights was to seek to have the case reviewed by the United States Supreme Court. However, the majority believed that to carry the *Agran* case further would be detrimental.

This report cannot presume to speak for each member of the Board, but it is believed that the following factors were among those influencing the members who voted to withdraw from further efforts in the Agran case:

1. That substantial opinion was received indicating that certified public accountants enrolled to practice before the United States Treasury Department may continue their customary practice before the Department without legal jeopardy or moral stigma.

2. That substantial opinion was received indicating that should the Supreme Court of the United States accept the case on appeal the chances of a decision favorable to accountants would not be good primarily for the reason that although the Treasury Department unquestionably has the right to lay down rules of practice before it and to preempt the field from jurisdiction of the various state courts it is not clear that it has, in fact, done so.

3. That certain high-ranked officials in the Treasury Department expressed the opinion that the Interpretation of Circular 230 adequately protects the rights of certified public accountants in federal tax practice, and that further pursuit of the Agran case would be viewed with disfavor.

4. That substantial opinion was received indicating that to pursue the *Agran* case at this point could create poor public relations for the profession.

5. That the Executive Committee of the American Institute of Accountants voted unanimously against participation in any effort to have the *Agran* case reviewed by the United States Supreme Court and expressed the hope that The California Society of Certified Public Accountants would also refrain from any such efforts.

It should be borne in mind that those who voted to pursue the case, as well as counsel for the State Society, would disagree with some of these opinions. Conversely, it should not be held that all of those who voted to discontinue participation in the case necessarily agree with every one of these opinions, but at least these seem to be some of the issues around which the final decision to abandon the matter did revolve.

The Board's decision to withdraw from any further participation does not signify acquiescence in the *Agran* decision. Counsel for the American Institute of Accountants and others indi-

*H Chapman Rose, former Undersecretary of the Treasury and one of the principal authors of the Interpretation of Circular 230 issued by Secretary of the Treasury George Humphrey in January 1956; John L. Carey, Executive Director of the American Institute of Accountants; Bruce Bromley of the firm of Cravath, Swaine and Moore, counsel for Price Waterhouse & Co.; Erwin N. Griswold, Dean of the Harvard Law School and author of several articles on the problems of the relations between lawyers and certified public accountants; Mathias F. Correa of Cahill, Gordon, Reindel & Ohl, counsel for the American Institute of Accountants, and the attorney who pursued the Bercu matter and was associated with the Agran case in its early stages; Earl Newsom of Earl Newsom and Co., public relations counsel for the American Institute of Accountants; Arthur Dean, attorney with the firm of Sullivan and Cromwell, counsel for Haskins & Sells; Fred C. Scribner, Jr., General Counsel for the Treasury Department and also one of the authors of the Interpretation; Russell C. Harrington, Commissioner of Internal Revenue; George C. Lea, Director of Practice, Internal Revenue Service; Reuben Clark, Jr., Washington attorney, who has made a study of the Agran case and has written several articles on the subject; Saul Levy, New York certified public accountant and attorney, and prominent member of the American Institute of Accountants, and the members of the American Institute of Accountants Executive Committee meeting in New York—Marquis G. Eaton, Chairman, Donald J. Bevis, William M. Black, Russell S. Bock, William S. Deeming, Gordon M. Hill, John B. Inglis, Donald P. Perry, L. H. Penney, R. Warner Ring and John H. Zebley, Jr.

cated their belief that enrolled agents in California would not, by continuing to represent their clients before the Treasury Department, incur any substantial risk of punitive action. The California Society of Certified Public Accountants intends to continue, as in the past, to defend vigorously the practice of certified accountants in the tax field. In reaching its decision the Board believes that it has acted in the best interests of the accounting profession.

RUDOLPH E. LINDQUIST
President

BY ORDER OF THE BOARD OF DIRECTORS
NOVEMBER 30, 1956

New data on income of accounting, law partnerships revealed by IRS survey

THAT MOST accountant and attorney partnerships have been enjoying the fruits of prosperity is well known, but the extent and the pattern of their incomes were not confirmed until recently when the IRS published a survey of partnership returns for the year 1953.

According to the figures in the survey, the average law partnership grossed $56,126, paid salaries and wages of $10,299, and had an ordinary net income of $32,624 for 2.8 partners. The average law partner had net income of $11,651.

Income for accounting partnerships were far above the national average of income for all U. S. partnerships, but nowhere as rosy as for attorneys. The average accounting partnership grossed $54,578, paid salaries and wages of $20,288, and had net ordinary income of $22,544 for 2.6 partners. Net profits per partner averaged $8,669.

The figures thus confirm the oft-repeated truism that accounting firms have higher payroll overhead, that their income is cut down by the requirements of a larger staff. Even though accounting and law firms had virtually the same average gross, their profit ratios were far apart. Lawyers' profits were 58.1% of the gross; accountants' were 41.3%.

Aside from the all-important salary and wage expense, the lawyers generally had higher overhead. On the average, they paid $2,661 for rent, $452 more than accountants. For other deductions, bad debts, etc., the average law firm reported $8,315, while accountants showed $7,550. And for "cost of goods sold," lawyers deducted $1,723, $335 more than accountants.

Items of income

Many of the items reported in income cause some surprise and may evidence investment patterns for the two professions. Besides the moneys earned directly from professional fees, which was of course the greatest source of income, the average accounting partnership earned $684 from other partnerships, pools, etc., but the law partnership averaged only $20 from these sources.

In all other important respects, the law firm's other sources of income earned more money. From dividends it earned $29, from rents $145, and from other income $374. Contrasted to these figures, the accounting firm earned $14 from dividends, $33 from rents, and $181 from other income. And total law-firm income from royalties was $182 million, which accounting firms matched with only $1 million.

Total figures for all important items appear in the accompanying Table.

Income of other partnerships

The figures confirm the fact that accountants and attorneys are among the highest paid partnerships. Only physicians, surgeons and oculists, who averaged almost $20,000 net income, and engineering and architectural partners, who averaged more than $13,000, earned more than attorneys. Surprisingly, dentists and dental surgeons averaged less—in fact, below $10,000. And the only others who either surpassed or came close to the accountant average were partners in the fabricated-metal-products industry, averaging $11,000; those in machinery manufacturing, averaging $11,500; and insurance agents and brokers, averaging about $7,300. ☆

TABLE 1 — PARTNERSHIP RETURNS FOR 1953

	Accountants	*Attorneys*
Number of returns	5,302	18,702
Number of partners	13,824	52,107
Receipts in thousands of dollars		
Gross receipts from business or profession	$284,537	$1,038,856
Net profits from other partnerships, pools, etc.	3,628	374
Dividends	74	540
Rents	173	2,710
Royalties	1	182
Other income	962	6,999
Total receipts	$289,375	$1,049,661
Deductions in thousands of dollars		
Cost of goods sold	$ 7,358	$ 32,227
Salaries and wages	107,569	192,611
Rent paid on business property	11,775	50,772
Depreciation	3,117	8,403
Other deductions, bad debts, etc.	40,029	155,521
Total deductions	$169,848	$439,534

Professional tax advice on a "hospitalization" basis?

WE WONDER whether the proponents of the pre-paid legal care plans now being talked about in some labor organizations have thought about tax work. If tax work is included in the plan, (and why shouldn't it be?) almost every member of the plan could conceivably want legal help. Surely tax troubles are just as legal as anything else, and what with all the talk about highpowered lawyers saving tax money for their clients, members of the plan may want to get in on the act.

One such plan, that proposed by the Los Angeles Joint Board of Hotel and Restaurant Employees would cover 20,000 members, would cost 2¢ per hour worked.

Our advice to the organizers is to remember that lots more people have a desire to save tax money than to sue somebody. ☆

NEW DEVELOPMENTS IN

Payroll taxes

EDITED BY PETER G. DIRR

An evaluation of costs and benefits under OASI as recently amended

by **BENJAMIN B. KENDRICK**

The social security law as recently amended adds considerably to the costs paid by employers and employees alike; it also increases benefits. This article analyzes who pays how much and who gets how much, and it offers some forecasts on the likely course of social security legislation in the immediate future.

WHEN H.R. 7225 became law on August 1, 1956, it marked the fourth consecutive Congress in which legislation substantially expanding social security has been adopted. Moreover, it is quite possible that a fifth round of social security expansion will be sought in the next Congress. Both the new early retirement provisions for women and the new disability benefit provisions create fresh possibilities for further liberalization of the OASI system. On the other hand, but perhaps less apparent, is a gathering body of evidence suggesting that the wave of social security liberalization that started in 1949-50 is beginning to die down. While amendments to OASI may be adopted from time to time in the future, it seems likely that such future enactments as may be seen will be less far-reaching than the legislation of 1950, 1952, 1954, and 1956. After a review of the chief features of the new amendments, these divergent implications are considered.

New disability benefit provisions

The most significant aspect of the 1956 Amendments is the entry of the OASI system into an entirely new field—that of providing monthly cash disability benefits. It is true, however, that permanent disability coverage in OASI had long been demanded and that the new cash benefit provisions had been definitely foreshadowed by the 1954 enactment of the so-called "disability freeze" or "waiver-of-premium" provisions. These provisions, incidentally, remain in effect under the new legislation, but separate from the cash benefit provisions.

While there is danger that the new provisions will be systematically expanded in the future, the approach of the 1956 legislation must be recognized as a cautious one. The initial caution is reflected in the following chief features:

1. *Definition of disability; waiting period.* Subject to a six-months' waiting period, disability is defined as being "inability to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration." The law explicitly puts the burden of proof of disability upon the claimant.

2. *Age and "insured-status" requirements.* Cash disability benefits are payable only to persons aged 50 or over but under age 65 (when old-age benefits commence). To qualify for disability benefits, the individual must be both "fully insured" and "currently insured," as defined in the law, and in addition must have 20 "quarters of coverage" under OASI out of the 40 calendar quarters elapsing just prior to the onset of the disability. The general effect of these provisions is to require both substantial and recent attachment to the OASI system.

3. *Restrictions on benefits.* The new monthly disability benefits are subject to four important restrictions: (a) Following an initial adjudication of disability, determinations of its continuance are to be made, as needed, with an individual's benefits subject to suspension, if warranted, pending such a determination; (b) Disability benefits under OASI will be reduced to the extent that any disability benefits are payable under any other federal plan or law, or under state workmen's compensation legislation; (c) The disability benefits will be withheld during periods of any considerable earnings, and (d) Disability benefits will be withheld if rehabilitation services are refused without good cause.

4. *Benefit amounts; no dependents' benefits.* An individual's disability benefit amount will be computed just as the monthly old-age benefit amount would have been computed had he reached age 65 at the time of onset of disability. However, benefits are not provided for wives and children of disability beneficiaries, although such supplementary benefits are provided for dependents of old-age beneficiaries.

Financing new benefits

As to financing, the schedule of future OASI payroll tax rates is revised upward to support the new disability-benefit program. The extra taxes collected by reason of the increased tax schedule will go into a separate Disability Trust Fund, from which the monthly disability benefits will be paid. Tax receipts attributable to the pre-existing schedule of tax rates will continue to go into the regular OASI Trust Fund.

The amount of the increase in the schedule of future tax rates is one-quarter of one per cent each on employers and employees and three-eighths of one per cent on the self-employed. Table I shows the new schedule of tax rates and its annual effect in dollars at the $4,200 annual ceiling on taxable earnings.

It is estimated that the higher tax rates will apply in the first year to 70 million employees and self-employed persons, and to 4.5 million employers. Total tax receipts are expected to be $8 billion in 1957 and to increase progressively thereafter, reaching $18 billion in 1975.

According to the official actuarial estimates, disability-benefit payments will amount to $116 million in 1957 (with the first payments to be made for the month of July), to $379 million in 1958,

and will increase steadily thereafter, reaching $949 million in 1975. For the first full year of operation, the number of beneficiaries is estimated at 250,000, while in 25 years' time the number is expected to reach one million.

Early-retirement benefits for women

Under the 1956 Amendments, OASI benefits will be available at age 62 for four categories of female beneficiaries—widows, surviving dependent mothers, working women, and wives. Widows and mothers will be eligible for benefits at 62 in the same full amount they could previously have received beginning at age 65. Working women will be eligible for 80 per cent of their full benefits at age 62, while wives will be eligible for 75 per cent of their full benefits at that age. Women workers and wives who apply for benefits between the ages of 62 and 65 will have their monthly benefit amounts determined on a *pro rata* basis.

Reduced benefits elected by women workers and wives will be continued in the reduced amounts after the beneficiaries reach age 65. However, the fact that a wife has elected early benefits in reduced amount will not prevent her receiving full widow's benefits if her husband dies.

It is estimated that about 800,000 women between the ages of 62 and 65 will be eligible to receive benefits under the new provisions for November, 1956, the first month for which they are payable.

Other OASI amendments

Under the new legislation, coverage is extended to about 800,000 additional farmers previously excluded and self-employed professionals other than doctors. In addition, separate new legislation, the Servicemen's and Veterans' Survivor Benefits Act, provides regular OASI coverage for members of the armed forces as a part of an integrated plan for military survivorship protection. Heretofore, service men and women have had limited OASI coverage on a special basis through gratuitous wage credits.

The OASI system now covers well over 90% of the gainfully occupied. The chief groups remaining excluded, other than self-employed physicians, will be irregular farm operators, irregular or casual farm and domestic workers, railroad employees (although they are linked to OASI through coordinating provisions with the railroad retirement system), most policemen and firemen employed by state and local governments, and federal employees under the civil service retirement system.

The new legislation also provides that, if permanently and totally disabled before reaching age 18, a child will be eligible to receive (or to continue to receive) OASI child's benefits indefinitely thereafter. Benefits will also be payable to mothers caring for such disabled children.

It is estimated that 20,000 disabled children aged 18 and over will be eligible for benefits under the new provisions initially (the first benefit payments to be made for the month of January, 1957). The number of disabled child beneficiaries will gradually increase thereafter, with about 2,500 being added each year.

Cost of new OASI amendments

The Table II, taken from official government figures, shows the relative costs of the various changes made in the OASI system by the 1956 Amendments. The figures, expressed as percentages of the covered payroll, are on a so-called "level premium" basis. They represent an intermediate-cost estimate—based, however, on an assumption of continued high-level employment.

Future demands for liberalization

As suggested at the outset and as discussed later, there is reason for hope that far-reaching liberalizations of OASI can be avoided in the future. However, as also suggested, the new disability benefit provisions and the new retirement age provisions open up two new and sizable areas in which new liberalizations are likely to be demanded.

Very likely an early liberalization to be sought in the disability benefit area will be the elimination or reduction of the age-50 requirement. Senator George, who led the forces seeking monthly disability benefits on the Senate floor, had this to say:

"Over one-third of all disabled persons are under the age of 50 and would not be immediately benefited by the proposal. Personally I am of the opinion that the age 50 requirement is arbitrary and unrealistic. . . . The younger person may have heavier financial and family responsibilities, less savings and resources than a man of 50 or 60 who becomes disabled. . . . But I am willing to go along with the more conservative, the more restricted policy embodied in the House-passed bill because our colleagues . . . have felt we should be careful and conservative in starting this program."

Senator Curtis, who opposed the monthly disability benefits on the Senate floor, was quite pessimistic in envisaging the further liberalizations that might follow. He stated:

"Is there anyone here so lacking in knowledge of our political system that they believe that this proposal, if enacted now, will not be added to at frequent intervals throughout the years to come? . . . I predict that it will be followed by a proposal to pay cash

TABLE II: OASI COSTS

Cost of 1954 Act:	
1954 estimate (based on 1951-52 earnings level)	7.77%
1956 estimate (based on 1955 earnings level)	7.45%
Cost of 1956 changes:	
Reduced age requirement for widows and mothers	+ .19%
Reduced age requirement for women workers and wives	+ .03
Monthly disability benefits after age 50	+ .42
Disabled child's benefits	+ .01
Extension of coverage	− .11
Revised interest basis for trust-fund investments	− .14
Total	+ .40%
Cost of system under 1956 Amendments	7.85%

TABLE I. TAX RATES

Year	*Tax Rates*			*Tax Amounts Payable at $4,200 Ceiling*		
	On Employees	*On Employers*	*On Self-Employed*	*By Employees*	*By Employers*	*By Self-Employed*
1956	2 %	2 %	3 %	$ 84	$ 84	$126
1957-59	2¼	2¼	3⅜	94.50	94.50	141.75
1960-64	2¾	2¾	4⅛	115.50	115.50	173.25
1965-69	3¼	3¼	4⅞	136.50	136.50	204.75
1970-74	3¾	3¾	5⅝	157.50	157.50	236.25
1975 and after	4¼	4¼	6⅜	178.50	178.50	267.75

[*Mr. Kendrick is Research Associate, Life Insurance Association of America. He has a long background of specialized research and writing in social security matters. This article is based on a similar, but longer article which appeared recently in the CLU Journal, and is used here with permission.*]

benefits in cases of temporary total disability. The next step may be the payment of cash benefits in cases of permanent partial disability, and even in cases of temporary partial disability. . . ."

While demands for temporary and partial disability benefits may not go as far as Senator Curtis fears, efforts to ease the various restrictive provisions previously listed as applying to the new disability benefits in OASI seem probable. There may also be an effort to add benefits for those who are dependents of disability beneficiaries. In any event, if very many liberalizing efforts should succeed, payroll taxes for disability benefits might easily have to reach one per cent each on employers and employees, wholly apart from the payroll taxes needed to support the regular OASI Trust Fund.

Concerning the retirement-age provisions, it seems likely that efforts will be made to extend the option of early retirement on actuarially reduced benefits from age 62 down to age 60, or even to age 55. And whatever early-retirement options are provided for women will no doubt be demanded for men as well. In general, proposals of this sort are subject to the objection that, if adopted, the OASI social-benefit system would increasingly take on the individual-equity characteristics of private insurance. Nevertheless, proposals to widen the area in which actuarially reduced benefits can be elected at ages below 65 would be difficult to resist because it would be argued that they meet a public need or desire while not adding appreciably to OASI costs.

Two other possible demands that *would* add appreciably to OASI costs are (a) to eliminate the actuarial reductions in the benefit amounts and to provide full benefits at ages under 65, or alternatively (b) to raise the level of all OASI benefits in order to keep the actuarially reduced benefits from being lower than some desire. Either of these steps would seem most unwise as well as being quite costly. But as discussed next, there is growing reason to hope that Congress will be much less ready in the future than in the past to add materially to OASI costs.

Growing reluctance to increase OASI

In the past the writer has expressed the thought that the only inherent brake on OASI expansion is for the payroll tax rates to become "high enough, and painful enough, so that voters will carefully scrutinize all proposals to increase benefits." Perhaps the nation is not too far from that point already.

The most important bit of evidence supporting this view is the gingerly way Congress approached the tax increases proposed by H.R. 7225. The version of the bill which passed the House provided full benefits at age 62 for all women beneficiaries, along with a payroll-tax increase of one-half of one per cent each on employers and employees. In the Senate Finance Committee, however, a large majority of the members were opposed to any increase in the OASI tax schedule. It said:

". . . it would be unwise to burden the millions of covered workers with increased social security taxes at this time, as would be required under the House-approved bill. Substantial tax increases were made as recently as January 1, 1954, when the rate was increased, and January 1, 1955, when the taxable wage base was raised to $4,200. It seems much wiser to confine improvements in the program to those that can be absorbed within the present tax schedule."

To achieve this aim, the Senate Committee completely eliminated the cash disability benefit provisions from the House bill and also eliminated the age reduction provisions applying to women workers and wives.

On the Senate floor, sentiment for and against a proposed amendment to put back in the bill the disability benefit provisions was almost evenly divided—final passage coming by a close vote. The age reduction provisions for women workers and wives were compromised—actuarially reduced benefits being provided at negligible cost, thereby permitting the payroll tax increases in the amended bill to be only one-half of what the House version had called for.

In the Senate-House Conference Committee on the bill, the Senate amendments were generally accepted, notably the actuarial reductions in the early retirement benefits for women workers and wives and the accompanying reduction in the payroll tax increases. Doubtless the House conferees recognized that the larger tax increases in the House version of the bill could hardly be popular with the public. (However, the House conferees would quite likely have insisted on the disability amendments in case they had been rejected by a narrow margin in the Senate.)

These facts, illuminated by the Congressional debates, seem clearly to show that Congress realizes the American people now—while glad enough to get more OASI benefits—are by no means happy to pay higher payroll taxes for them. In short, OASI taxes are now reaching a level where they are beginning to hurt. Especially being hurt is the politically potent group of self-employed farmers, who must pay their higher taxes in lump sums from their own pockets, and not by the relatively painless payroll-deduction route. For many farmers, social security taxes are already a heavier burden than federal income tax.

The point that social security taxes are beginning to hurt is all the stronger when it is considered that OASI is still offering seeming bargains. Most Americans have simply no idea that a whole schedule of tax increases is to take effect between now and 1975. And these tax increases are required merely to meet the costs of the present benefit provisions—they cannot be used to provide additional benefits. When the American people have been unpleasantly surprised by having to meet the first one or two of the scheduled tax increases, with no corresponding increase in benefits, they will be even less willing than at present to pay still higher taxes for new liberalizations in the benefit provisions.

As it becomes increasingly apparent to the American people that social security benefits are not free, or even cheap, they can be counted on to take a closer

tax problems?

For the quick answer to *all* Federal tax questions, keep Alexander's Federal Tax Handbook, 1957 Edition, on your desk at all times. See back cover for order blank.

look than in the past (when tax rates were low and there were "bargains" galore for particular individuals) at whether they really need the extra protection that further liberalization of the OASI system might bring them.

A large and growing proportion of people will surely conclude that they do not want to pay for further social security. Life insurance in force is at a record high; pension plans are spreading and being liberalized; home ownership and savings bank deposits are up; and in general, because of increased voluntary effort, people just do not have the same need for compulsory social protection as they may formerly have had. While a majority may be willing to buy a little more social security at intervals in the future, it seems rather unlikely that a majority will ever be willing to pay for broad new OASI liberalizations.

Meanwhile, all those interested in maintaining social security on a sound basis can make a contribution by doing what they can to increase public awareness of the costs and payroll taxes of the OASI system. With knowledge of present and future costs and taxes to balance the widely available knowledge about benefits, voters can be expected to bring the trend toward social security overexpansion gradually to an end. ☆

Employer's statement on sick pay that employee can use

THE IRS HAS just issued a form of sick-pay statement which employers can give to their employees to be attached to the employee's return. *Rev. Proc.* 57-1 explains the need for this kind of statement:

This Revenue Procedure sets forth the conditions under which an employer-issued statement, showing an employee's sick pay excludable from gross income under Section 105(d) may be attached by the employee to his individual income tax return in satisfaction of the instructions requiring the employee to attach a statement showing a computation of excludable sick pay and indicating the periods of absence, nature of illness or injury, and whether he was hospitalized.

The Employment Tax Regulations provide that withholding is not required upon wage-continuation payments to the extent that such payment is excludable from the gross income of the employee under Section 105(d), provided the employer maintains certain records specified in the Regulations.

Revenue Procedure 56-17, sets forth conditions under which employers may show separately on Form W-2 the payments excludable, under Section 105(d), which are made directly by them. However, in such cases, regardless of whether tax was withheld on such excludable amounts, employers must keep the records described by the Employment Tax Regulations. The fact that excludable sick pay may be reported separately on Form W-2 will not relieve the employee of the necessity of submitting the statement which is required to be attached to his individual income tax return showing the computation of excludable sick pay and indicating the period or periods of absence, nature of illness or injury, and whether hospitalized.

Employers having in effect wage-continuation plans have requested permission to issue to their employees statements of excludable sick pay which such employees could attach to their individual income tax returns in lieu of the presently prescribed statement. These employers point out that the determinations made by them of excludable sick pay are fully supported by the type of records specified in the Regulations. It was suggested that adoption of such a procedure would be mutually advantageous to employer and IRS.

Employers having wage-continuation plans who keep the records required by the Regulations may issue statements to their employees of excludable sick pay which, when attached to the employees' individual income tax returns, will satisfy the present requirements for a statement supporting the sick pay exclusion, provided the employer also complies with the following:

1. Assumes full responsibility for the accuracy of the sick-pay figures furnished to its employees, and keeps the payroll records supporting such figures available for inspection by Internal Revenue Service personnel;

2. Lists the excludable sick pay in a separate block on the Forms W-2 furnished to the employees; (Listing on Forms W-2 for the year 1956 may be shown separately. The Form W-2 for 1957 will specifically provide a separate block for this purpose adjacent to the block for total wages paid); and

3. Executes and issues to each employee involved a statement in substantially the accompanying form.

STATEMENT TO SUPPORT EXCLUDABLE SICK PAY

. . . . . .

(Name of employee)

. . . . . .

(Address of employee)

On the 1956 withholding tax statement, Form W-2, furnished to you by this corporation, sick pay excludable under Section 105(d) of the Internal Revenue Code of 1954 in the amount of $. . . . . is shown. If you claim this exclusion on your 1956 income tax return, the Internal Revenue Service instructions pertaining to the filing thereof require you to enclose with your return a detailed computation in support of such sick pay exclusion. However, in view of the payroll records maintained by us, we are authorized under Rev. Proc. 57-1, I.R.B. 1957-2, to advise you that this statement will satisfy the Service's instructions and that, when you file your return, you may attach this statement thereto in lieu of the detailed computation required by the Service's instructions.

I, the undersigned officer of the corporation, declare under the penalties of perjury that the excludable sick pay shown above is, to the best of my knowledge and belief, an accurate determination based upon the records of the corporation, which records are available for inspection by Internal Revenue Service personnel.

. . . . . .

(Name of employer)

By . . . . . .

The accompanying statement was designed for use by a corporate employer. Whenever this statement is used by a partnership or a sole proprietor, it should be appropriately modified.

NEW DEVELOPMENTS IN

State & local taxation

EDITED BY JOSEPH P. STAPCHINSKAS

State tax men in quandary over denial of certiorari in Michigan's Panhandle case

WITH THE REFUSAL of the United States Supreme Court to grant the application of the State of Michigan for a writ of certiorari, state tax men are looking long and hard at the Michigan Supreme Court decision in the case of *Panhandle Eastern Pipeline Company v. Michigan Corporation and Securities Commission et al*, 77 N.W. 2d. 249.

The *Panhandle* case involved the Michigan franchise tax which is imposed on corporations for the privilege of doing or being able to do business in the State of Michigan. The business of Panhandle, a Delaware corporation qualified to do business in the State of Michigan, consisted of the production, purchase, transportation by pipeline, and sale of natural gas in various states. In Michigan, Panhandle sold gas produced locally as well as gas transported from other states; thus, it conducted both an intrastate and an interstate business in that state. Under its franchise tax law, the State of Michigan attempted to impose a tax on the portion of Panhandle's paid-up capital and surplus which, upon apportionment to Michigan by a three-factor apportionment formula comprised of the factors of Michigan sales, payroll, and physical property to total sales, payroll, and physical property of the taxpayer, formed the base to which the rate of tax was applied. The Michigan Supreme Court decided that the commerce clause of the Federal Constitution prohibited the inclusion of receipts from Panhandle's sales of gas transported into Michigan by pipeline from extra-Michigan sources, in the numerator of the sales factor.

The Michigan Corporation and Securities Commission, we are informed, intends administratively to confine the *Panhandle* decision to corporations identically or near-identically situated. Nonetheless, a flood of applications for refund of the Michigan franchise tax paid by corporations other than interstate carriers has deluged the Commission. Whether the rationale of the *Panhandle* decision has equal force with respect to non-carriers and might affect tax laws of other jurisdictions which require the inclusion of receipts from interstate sales in the computation of their tax bases presents a problem to which state tax men must apply themselves.

The constitutionality of a state tax law frequently depends upon the character of the levy. Basically, taxes fall within these categories: property, privilege, and income. A franchise tax is within the privilege tax classification. In order for a state to levy any privilege tax it must confer upon the taxpayer a privilege which the state is free to grant or withhold. Accordingly, it has been taken to be fundamental that a state may not impose a tax for the privilege of conducting a purely interstate business.

When called upon to consider the constitutionality of state privilege taxes, the United States Supreme Court addresses itself to two inquiries:

1. Is the *subject* of the tax proper?

2. Does the *measure* of the tax satisfy the limitations imposed thereon by the Federal Constitution?

Manifestly, if the tax being reviewed does not satisfy the first requirement, the measure of the tax, however valid the exaction may be otherwise, is immaterial. *Spector Motor Service, Inc. vs. O'Connor*, 340 U.S. 602.

The constitutional validity of state privilege taxes imposed on foreign corporations which conduct an interstate as well as intrastate business within the territory of the taxing state, is firmly established. Further, and more importantly for purposes of this discussion, the United States Supreme Court has confirmed the authority of the states to include receipts from interstate sales in the numerators of apportionment fractions by which the tax bases were determined. *E.g., International Harvester Company v. Evatt*, 329 U.S. 416; *Western Cartridge Company v. Emmerson*, 281 U.S. 511; *Hump Hairpin Mfg. Company v. Emmerson*, 258 U.S. 290.

Unhappily, the principles of such decisions are not applied with constancy or consistency. That state tax men are confounded as to the constitutional limits of the jurisdiction of the states to exercise their taxing powers is understandable: no reliable standards exist by which such a determination may be made with any degree of confidence.

In evaluating the *Panhandle* decision state tax men must consider the case of *International Harvester Company v. Evatt, supra*, which involved a franchise tax on a foreign corporation's capital stock apportioned to the State of Ohio by a formula one of whose factors included in its numerator receipts from interstate sales of the taxpayer. In unqualifiedly validating the levy, the United States Supreme Court said:

"Plainly Ohio sought to tax only what she was entitled to tax, and there is nothing about application of the formula in this case that indicates a potentially unfair result under any circumstances. It is not even contended here that the amount of these taxes could be considered to bear an unjust or improper relation to the value of the privilege of doing business in Ohio if the legislature had imposed a flat franchise tax of the same amounts of the respective years which application of this formula has produced. See *Hump Hairpin Co. v. Emmerson, supra* at 296. Furthermore, this Court has long realized the practical impossibility of a state's achieving a perfect apportionment of expansive, complex business activities such as those of appellant, and has declared that 'rough approximation rather than precision' is sufficient. *Illinois Central Ry. v. Minnesota*, 309 U.S. 157, 161. Unless a palpably disproportionate result comes from an apportionment, a result which makes it patent that the tax is levied upon interstate commerce rather than upon an intrastate privilege, this Court has not been willing to nullify honest state efforts to make apportionments. * * * A state's tax law is not to be nullified merely be-

cause the result is achieved through a formula which includes consideration of interstate and out-of-state transactions in their relation to the intrastate privilege." 329 U.S. 416, 422-423.

Let's look at the *Panhandle* case. Here sales to Michigan customers accounted for 40% of taxpayer's total receipts. Yet, the Michigan Supreme Court ruled that the state might not apportion 9.2528% of the taxpayer's paid-up capital and surplus to the state in measuring the value of the privilege exercised by Panhandle in the State of Michigan. "Why?" state tax men ask themselves. Certainly not because a "disproportionate" amount of Panhandle's capital stock and surplus is thereby apportioned to the State of Michigan.

The quandary is compounded by the decision of the United States Supreme Court during this current term of the case of *Field Enterprises, Inc. v. Washington,* 352 U.S. 806. There the court affirmatively sanctioned the imposition of a *privilege tax directly on the unapportioned gross receipts of a taxpayer who conducted no intrastate business in the taxing state.* How is this decision to be reconciled with the precepts of (1) lawful subject of taxation and (2) proper measure of the exaction. In the light of the *Field* case, what is the effect of the *Panhandle* decision?

Despite the confused constitutional status of the taxing powers of the states, the state tax man cannot ignore the *Panhandle* decision and its possible relationship to those 19 other states which levy a franchise tax whose apportionment formula is similar to that denounced in *Panhandle.* He should analyze this decision carefully in considering whether applications for refunds should and might be filed under the franchise tax laws of the States of Arkansas, Colorado, Florida, Georgia, Kansas, Kentucky, Louisiana, Mississippi, Missouri, New Jersey, New Mexico, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, Texas, Washington and West Virginia.

It is fair to say that whatever his determination may be he will find himself in disagreement with fellow state tax men until such time as the United States Supreme Court more precisely defines the constitutional limits of the taxing jurisdiction possessed by the several states. ☆

Mass. case holds deliveries out of state are interstate; not includible in formula

LIKE THE *Panhandle Eastern Pipe Line Co.* case in Michigan, another sales allocation case is starting up the judicial ladder, this one in Massachusetts. This is the *John H. Breck, Inc.* case; the decision on which was originally promulgated on April 12, 1956 but released in November 1956.

Our colleague, Peter G. Dirr, editor of THE JOURNAL's department on Payroll Taxes (and vice president of McKesson & Robbins, Inc.), sends us this comment on the case:

The *Breck* case is a decision of the Massachusetts Appellate Tax Board holding, in effect, that certain sales of a domestic corporation, having its principal place of business in Springfield, Massachusetts, which required deliveries outside the State of Massachusetts from the corporation's inventory in Massachusetts, were sales in interstate commerce and not to be included in the numerator of the gross receipts factor.

In this particular case, the sales of the appellant, John H. Breck, Inc., were segregated into five classes as follows:

Five classes of sales

a. Sales by a Massachusetts sales office to Massachusetts dealers and customers, delivery being made from stock in Massachusetts to a point in Massachusetts.

b. Sales by salesmen resident in Massachusetts to out-of-state dealers and customers, delivery being made outside Massachusetts from stock in Massachusetts.

c. Sales by salesmen resident outside Massachusetts to out-of-state dealers and customers, delivery being made outside of Massachusetts from stock in Massachusetts.

d. Sales by New York sales office to out-of-state dealers and customers by salesmen resident out-of-state, delivery being made outside Massachusetts from stock in Massachusetts.

e. Sales by out-of-state sales office to out-of-state dealers and customers, delivery being made from stock out of state to a point outside of the state.

Massachusetts law

The Massachusetts law requires that the numerator of the gross receipts fraction should include all sales other than those attributable to out-of-state offices owned or rented by the taxpayer. Accordingly, in the agreed facts, it was conceded that sales in item (a) were properly assignable to Massachusetts and in items (d) and (e) not assignable to Massachusetts.

Thus, the issue revolved around sales classified in items (b) and (c). While the instant decision does not specify whether the salesmen soliciting the sales in items (b) and (c) above were associated with the Springfield office or not, such an assumption might be indirectly made since items (d) and (e) specifically referred to sales made by the New York sales office and other sales offices located outside the State of Massachusetts. The only distinction between the sales set up in items (b) and (c) is that in one case the salesmen soliciting the business were residents of Massachusetts and in the other case they were nonresidents.

The Appellate Tax Board emphasized that the Massachusetts tax was not a property tax but rather an excise tax composed of two segments—one measured by "corporate excess" and the other by net income. Quoting from the case of *Springdale Finishing Co. v. Commonwealth,* 242 Mass. 37, 40, the Appellate Tax Board said in part: "Although both property and income are used as a basis for its calculation, the tax is nevertheless an excise on the commodity of exercising the corporate franchise and not a tax on property or on income."

We will keep our readers advised of development in this case. It could have far-reaching effects. ☆

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NEW DEVELOPMENTS IN
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Rep. Mills outlines plans for technical revision of Code: opposes tax cuts now

ACTUAL EXPERIENCE to date with provisions of the 1954 Code where major efforts for technical and substantive revision were made (corporations, partnerships, estates and trusts, accounting rules) have shown them deficient in terms of administrability, compliance, and fairness, says Representative Wilbur D. Mills, (D. Ark.). Mr. Mills, who is chairman of the Tax Policy Subcommittee of the Joint Committee on the Economic Report and Chairman of the Subcommittee on Internal Revenue Taxation of the House Ways & Means Committee, outlined his views on the need for technical revision of the Code at the annual dinner of the Federal Tax Forum of New York last month.

Mr. Mills' views are of especial importance to tax men now; his extensive experience with tax legislation in the last several years, and his present dominant position, give his estimate of forthcoming changes unusual validity. Many consider Mr. Mills to be emerging a dominant figure in taxation for a very long time to come. In view of the important posts he holds in the world of tax legislation, his youth and considerable personal magnetism augur well for his longevity as a major force in tax policy.

The following are Mr. Mills' words, somewhat abridged.

Change in fiscal picture

The war wrought great changes in the American economy and its institutions. Among these were basic, structural revisions in our Federal tax system.

In the fiscal year 1941, for example, excises were the most important revenue producers in our fiscal system, accounting for 36% of Federal budget receipts. Corporation income taxes ranked second, producing about 29% of total receipts, while individual income taxes were a poor third, representing less than 20% of Federal revenues. Total Federal budget receipts amounted to only $7.1 billion.

Today, net budget receipts for the current fiscal year are estimated at $69.8 billion, nearly ten times the 1941 total. Almost half of that total comes from individual income taxes, 30% from corporation income taxes, and only 13% from excises.

These changed relationships reflect primarily the structural revision made necessary by the demands of war finance.

It is hardly surprising that today, in an economy which would scarcely have been recognizable 15 years ago and which each year brings new developments and problems, we are again—or I should say, still—concerned with changing our internal revenue laws. The challenges today are no less demanding than in former years.

According to the midyear budget review, the Federal Government's receipts in fiscal 1957 will be $69.8 billion—about one-sixth of our gross national product during that period. There is, I venture to say, not a single economic activity which is not affected and conditioned by our Federal tax laws. Evidence of the enormous impact of the Federal tax system is constantly brought to the attention of the Congress and the Administration by demands from taxpayer groups for tax revisions, and these demands are constantly increasing in scope and complexity. The professional journals of lawyers, accountants, and economists are replete with instances of the way in which taxes affect decision-making at the personal and business level, and with arguments for and against various approaches to tax reduction on the basis of their alleged importance to the nation's economic development. In short, without losing sight of the basic purpose of Federal taxation—raising revenues to defray the expenses of government—there is an ever-widening awareness of the significance of the Federal tax structure in shaping the complexion of our economic growth.

1954 Code was the answer

This awareness led to the broad program of tax changes which culminated in the Internal Revenue Code of 1954. There was in 1953 a general realization that our changing economy required review of existing tax law to determine how well it conformed with the nation's long-range economic requirements and with our standards of justice and fairness. No one, I am sure, will quarrel with these broad objectives.

Vast amount of work done

In terms of the resources committed to the job, the Revenue Act of 1954 was a monumental undertaking. Over 15,000 replies to a questionnaire prepared by the Staff of the Joint Committee on Internal Revenue Taxation were submitted and analyzed by the Committee on Ways and Means. More than 600 witnesses appeared before the Committee to testify on 40 major topics of tax revision. Over 300,000 man-hours were devoted by staff experts in the Treasury, the Internal Revenue Service, and the Joint Committee in the preparation of H.R. 8300. Extensive hearings and staff work also went into the progress of the bill on the Senate side, after it left the House.

A vast number of significant improvements were made in our tax structure by the 1954 Code. Neverthless, it soon became evident that in many important respects, the bill failed to meet the demands for simplification, greater equity, and closer conformity with the economic facts of life.

Relief measures boomerang

Throughout the income tax sections of the Code, for example, efforts were made to afford tax relief in the hardship cases which had been brought to the attention of the Committee and the Treasury. Today we find numerous instances in which these provisions have failed to achieve this objective or have resulted in demands for equivalent relief from similarly situated taxpayers

who, because of superficial differences, do not qualify for the benefits in the present law.

In the revision of the income tax, efforts were also made to eliminate tax obstacles to customary and respectable practices in the management of business and personal affairs. Today we find that, having done so, we have also opened up new, unsuspected avenues of tax avoidance. The 1954 Act sought to provide greater precision in the law in order to minimize taxpayer uncertainties and therefore ease compliance and administrative burdens. Today we find new uncertainties have replaced old ones and that the application of the new provisions imposes burdens of confusion and complexity which are an even match for those in the old Code. Finally, the new Code was intended to remove tax barriers to business growth and to encourage certain activities which, presumably, were peculiarly important to economic development. Today we find a highly unbalanced growth in which new and small businesses are lagging behind their big, established rivals. We are also hard put to justify discrimination in tax treatment among creative activities which are apparently equally valued by the economy as a whole.

Four areas of difficulty

Outstanding examples of these failures are to be found in four areas in the 1954 Code in which a substantial part of the technical revision work was concentrated. First, there are the provisions of Subchapter C dealing with corporate organizations, reorganizations, distributions, and liquidations. Second, the provisions of Subchapter K dealing with partnerships. Third, the provisions of Subchapter J covering the income tax treatment of estates and trusts. Fourth, the new accounting rules in Subchapter E. There were, of course, important substantive changes in numerous other areas covered by the income, excise, estate and gift taxes.

Actual experience to date in these areas ot the Code where major efforts for technical and substantive revision were made have shown them deficient in terms of administrability, compliance, and fairness. Additional evidence is found in the difficulty which the Treasury Department, despite its wholly commendable efforts, has found in issuing Regulations pursuant to these new statutory provisions. It has had to resort, as perhaps never before, to interpretation of statutes which were intended to eliminate the need for administrative discretion and ruling. In many instances, it has had to gloss over provisions, the precise application of which has so far defied the capacity of our vocabulary. And in many other instances, it has been necessary, apparently, to rely on judicial and administrative rules and interpretations under the 1939 Code to satisfy the daily demands of administration.

1939 rules still used

Apart from the errors of commission, the 1954 Code reflects numerous errors of omission. Many provisions of the 1939 Code pertaining to some of the most pressing problem areas were carried over virtually unchanged into the new law, at least insofar as the basic substance of these provisions is concerned. An outstanding example is afforded by Subchapters O and P, dealing with capital gains and losses. Since the inception of the income tax, the tax lawmaker has been plagued with problems of definition in this area. We have seen capital gains treatment extensively proliferated to the point where it now applies to a significant number of transactions in which nothing recognizable as a capital asset or as a sale or exchange is involved. The Revenue Act of 1954 made no contribution toward resolution of these difficulties, but rather added to them.

On balance, I have had to conclude that much of the work of structural improvement in our tax system remains to be done.

Legislative difficulties

As a result of our experience in the preparation of the Revenue Act of 1954, many members of the Ways and Means Committee became more than ever aware of the tremendous burdens imposed on them in discharging their responsibility. All too often, the members of the tax-writing committees in the Congress are called upon to pass on the merits of proposed legislation without adequate opportunity to determine its impact. In our world of highly complicated economic relationships, the task of defining and measuring taxable income is formidable. Legislation which alters such definitions and measurements may affect the business and personal financial decisions of millions of taxpayers. It may require significant changes in administrative practices and impose increased compliance costs on taxpayers in assuring inclusion in or exception from its application. It may involve substantial changes in Government revenues and require modifications in the distribution of tax burdens. Finally, it may require widespread technical changes in other areas of the tax law.

How subcommittee works

Let me describe briefly the work of the Subcommittee on Internal Revenue Taxation, which it is my great privilege to serve as chairman.

The broad purpose of the Subcommittee is to make a close, objective review of the major provisions of the Internal Revenue Code of 1954. I say "objective" advisedly. The spirit of the Subcommittee is one of searching, constructive appraisal and criticism, as devoid as possible of partisan bias. We seek to build upon the present to attain the best possible tax law and to establish a precedent in the revision of the nation's tax system based on a nonpartisan approach.

The Subcommittee's work, as now organized, has two major aspects: One involves an investigation of the substantive policy and technical adequacy of the statute, and the other is concerned with the administration and enforcement of our tax laws. In connection with the first aspect, our initial approach has been a review of a number—certainly not all—of technical and clerical errors, ambiguities, and instances in which unintended benefits or hardships have been experienced by taxpayers. As you know, hearings on a list of such hardships and benefits and staff proposals for their correction have recently been concluded. This initial phase has served not only to clarify issues in many cases, but to establish a strong foundation for cooperation among the Subcommittee and the staffs serving it, and the Treasury Department and Internal Revenue Service. It has also served, I am confident, to establish the nonpartisan character of the Subcommittee's work. It is only on this basis that real progress can be made in providing long-range, forward-looking improvements in our tax laws.

A second phase of the Subcommittee's endeavors is now under way. Advisory groups have been established to investigate the substantive policy and technical problems in Subchapters C, J and K, and a fourth advisory group is

PERSONNEL OF WAYS & MEANS TAX ADVISORY COMMITTEES

FOUR SPECIAL COMMITTEES have been appointed by Rep. Mills to advise the Subcommittee on Internal Revenue Taxation of the Ways & Means Committee. An Advisory Group to consider administration of Federal tax laws is composed of:

John H. Alexander
Mudge, Stern, Baldwin & Todd
New York, N. Y.

Maurice Austin
Austin & Diamond
New York, N. Y.

Michael D. Bachrach
Bachrach, Sanderbeck & Co.
Pittsburgh, Pa.

Bernard H. Barnett
Greenebaum, Barnett & Wood
Louisville, Ky.

Kenneth W. Bergen
Bingham, Dana & Gould
Boston, Mass.

Eugene F. Bogan
Sharp & Bogan
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Allan H. W. Higgins
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Dallas, Texas

J. B. Jarratt
Jarratt, Jenkins & Gay
Wichita Falls, Texas

Harry K. Mansfield
Ropes, Gray, Best, Coolidge & Rugg
Boston, Mass.

Robert N. Miller
Miller & Chevalier
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Leslie Mills
Price Waterhouse & Co.
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Corporate problems

The committee to advise on problems arising under Sub-Chapter C is composed of:

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Montgomery, McCracken, Walker & Rhoads
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Freeman-Shapard and Story
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Trusts and estates

The Advisory Group to deal with taxation of trusts and estates under Sub-Chapter J is composed of:

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Harvard Law School
Cambridge, Mass.

Carlysle A. Bethel
Wachovia Bank and Trust Co.
Winston-Salem, N. C.

Rupert Gresham
Boyle, Wheeler, Gresham, Davis & Gregory
San Antonio, Tex.

George L. Craven
Philadelphia, Pa.

James P. Johnson
Bell, Boyd, Marshall & Lloyd
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Laurens Williams
Sutherland, Asbill and Brennan
Washington, D. C.

studying the problems confronting the Internal Revenue Service in administration and enforcement of the provisions of the 1954 Code. We have been fortunate in securing for these groups the services of many outstanding tax lawyers and accountants, who will be assisted by the able staffs of the Ways and Means Committee, the Joint Committee on Internal Revenue Taxation, the Treasury Department, and the Internal Revenue Service. [For personnel of these committees, see box.]

Without in any way minimizing the importance of the work so far done and now under way, I must point out that it represents only a beginning in the task of revising our tax system in the light of basic standards of fairness, simplicity, and economic adequacy. The requirements of all of these standards point to the same objective — a tax system characterized by simplicity, relative ease of compliance and administration, absence of discrimination, neutrality in impact among alternative uses of productive resources, a high degree of responsiveness to changes in economic conditions, and finally, lack of bias against new and small businesses. Enumeration of these standards and characteristics highlights the magnitude of the job still to be undertaken.

Consider some of the problems of tax policy which will, undoubtedly, face the new Congress. Prominent among these will be, I am sure, the issue of tax relief for small business.

Specific measures now before us

Both major political parties have held out hopes for tax relief for small businesses. The substance of most of these proposals is to provide tax reductions for incorporated businesses, either through introduction of a graduated corporation income tax or by decreasing the present normal tax.

I recognize the need for tax relief for small businesses, but I must question the advisability of providing such relief only for small corporations while doing nothing for the vastly greater number of small partnerships and proprietorships which are the backbone of our enterprise system.

The number of unincorporated small businesses in the United States vastly outnumbers the number of corporations. I am told that only 64,000 corporations have income in excess of $25,000 per year. As a matter of fairness and in the interests of strengthening the small business foundation of our economy, I do not see how we can justifiably provide tax relief for "small" corporations and do nothing for the millions of entrepreneurs who because of sound business reasons or statutory proscription are unable to avail themselves of the corporate form.

Many of these proposals for small-business tax relief would create more severe problems than they would hope to solve. Because of our failure adequately to integrate the tax treatment of corporations and their owners, there remains a wide array of equity problems which would be greatly complicated or aggravated by many of the proposals which have recently been offered. What is required is the closest and most rigorous possible study of the whole area of small-business taxation to assure ourselves that revision will serve the interests of fairness and broadly based economic growth.

Certainly the spotlight this coming year—as every year—will be focused on the question of general tax reduction. It is important, I believe, that we view this issue in the economic setting we may expect next year.

Tax reduction considerations

There is today the widespread view that economic growth will continue in 1957, accompanied by continuing inflationary pressures. The serious international situation, technological advances in our defense establishment, and general cost increases are expected to result in a rise in Federal Government outlays. State and local government spending is expected to increase during the coming year. Current reports point to a continued rise in 1957 in total private investment, although at a much slower rate than in 1956. The persistent upward trend in disposable personal income is expected to result in further ex-

pansion of consumer spending, which may be bolstered by favorable reaction to the new automobiles. Finally, rising demand abroad contributed to the expansion of the United States domestic economy in 1956. Although recent developments, particularly in the Near East, introduce new uncertainties, further stimulus from this source in 1957 remains a possibility.

It is widely expected that prices will continue their upward trend next year as a result of the pressure of these increases in demand upon available resources.

It is still too early to be sure whether these views concerning economic developments in 1957 are correct. Nevertheless, the possibility that they may prove accurate leads me again to call attention to the principle set forth by the Tax Policy Subcommittee of the Joint Economic Committee in its report of December 1955.

The Subcommittee's report stressed the importance of relating tax policy decisions to economic conditions, as well as to the budgetary situation. The Subcommittee pointed out that with a rising level of economic activity and upward price pressures, tax reductions in 1956 would have inflationary consequences. The Subcommittee recommended that so long as inflationary pressures continued, budget surpluses should be applied to reducing the Federal debt.

Both the Administration and Congress followed this principle during this past year. By continued fiscal restraint, the Government contributed materially to economic stability. This fiscal responsibility—demonstrated in the face of election-year pressures for tax reductions—served to limit upward price pressures evident throughout 1956.

This principle calls for fiscal and monetary restraints so long as inflationary conditions persist. If the present outlook for 1957 is correct, use of a budget surplus for tax reduction would aggravate prevailing inflationary strains, requiring monetary policy to carry a greater, and perhaps excessive, burden for maintaining economic stability. Tax-policy proposals involving revenue losses, therefore, should be deferred until it is clear that they will not contribute to economic instability.

Although it is not possible to make accurate budget estimates for fiscal 1958, numerous indications suggest that at best the surplus will be too small to permit balanced tax reduction.

In the interest of minimizing the inflationary pressures which might result from reducing the budget surplus—or possibly incurring a deficit—I urge extension of those tax rates which under present law are scheduled to be reduced on April 1, 1957.

If during the coming months it becomes apparent that inflationary forces have subsided and that a stimulus to total demand is needed to maintain full use of our growing productive capacity, we will be in a position to enact a carefully balanced program of tax reduction and thereby provide continuing impetus for further real growth in the economy. Tax reductions should be postponed, however, until actual events indicate this occasion for them.

Of course, improvements in the structure of our revenue system are always desirable. In the interest of assuring realization of the economy's growth potentials, efforts should be continued to build more automatic stabilizing capacity into our revenue system, and to eliminate those tax provisions which contribute to misuse of resources. The revenue effects of these revisions, of course, must be carefully weighed in the light of prevailing economic conditions.

The challenges that face us in the area of fiscal and tax policy are extremely demanding. It is my hope that the Subcommittee on Internal Revenue Taxation will be authorized to continue its studies in the coming session of Congress to help in meeting these challenges. If this hope is realized, I am confident the work of both the Committee on Ways and Means and its subcommittees, with the cooperation of the Treasury Department and the Internal Revenue Service will point the way toward major improvements in our Federal tax system. ☆

NAM's recommendations on changing Code

THE NATIONAL ASSOCIATION of Manufacturers has sent to the Joint Committee on Internal Revenue Taxation these (among other) suggestions for amending the 1954 Code:

Section 37(c) includes as retirement income of persons over 65 pensions and annuities, interest, rents, and dividends. But in the case of persons under 65, only income from pensions and annuities under a public retirement system are eligible for the retirement income credit.

LAWYERS AVERAGE $10,200

THE AVERAGE net income of practicing lawyers was $10,220 in 1954, the Commerce Department has reported. The median income of lawyers—meaning the net earnings of the middle lawyer in the income spread—was $7,830.

The NAM thinks that persons under 65 who receive pensions from private or industrial retirement systems should be accorded the same retirement-income credit as those retired under a public-retirement system.

The NAM also would extend to others the permission given to outside salesmen to deduct their business expenses. Section 62(2)(D) provides for the deduction of expenses attributable to a trade or business carried on by the taxpayer if such trade or business consists of the performance of services by the taxpayer as an employee and if such trade or business is to solicit, away from the employer's place of business, business for the employer. The NAM requests that this provision be made applicable to all outside representatives of an employer and not just to solicitors of business.

Also recommended: Amend Section 165 (deductibility of casualty losses) to permit a deduction for casualty losses equal to the expenditures necessary to restore the property to its condition of usefulness or aesthetic properties prior to the casualty.

[We agree that the personal casualty-loss rules are difficult to administer; but it seems to us that determining whether aesthetic properties have been restored or enhanced would be "less certain" than determining loss of value or basis. —*Ed.*] ☆

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Tax aspects of retiring an interest in a small company with a buy-sell agreement

by **JOHN S. PENNELL**

At one time or another, any owner of a prosperous close corporation must consider carefully entering into an agreement covering the disposal of his stock at death or retirement. Of such agreements, there are many forms, each with advantages, each with tax hazards. Deciding which form to use is only one problem; because the tax law is ever changing, periodic reviews are necessary. For both stages, the drawing-up and the review, this article details the objectives to consider, the law, and the practical considerations involved in obtaining the advantages and avoiding the disadvantages in this type of buy-sell agreement.

THERE IS no single form of buy-sell agreement, because no single purpose is served by them. In one case, the agreement may be designed primarily to retain corporate control and stock-appreciation potential in the hands of the persons who expect to be actively engaged in the conduct of the business after the decedent's death. In another, the dominant purpose may be to provide an assured market for the decedent's stock—a matter of considerable importance, since the stock may well constitute his principal asset. In other cases, the agreement, looking to potential estate tax liabilities, may be designed to control stock valuation at the death of a stockholder. Finally, the agreement may be intended principally as a means of removing funds from the corporation without income tax liability, or at a nominal capital gains burden.

The first problem in considering the buy-sell agreement is to determine which of these objectives is to be attained because, while all of them may be desirable, they are not all mutually compatible. For example, an agreement intended to depress estate tax valuation may not also give the stockholder's family the full and fair value for his interest in a closely held corporation.

Even if the objectives are consistent, they may not be equally attractive to all parties concerned. The young active executive who owns half of the stock of a two-man corporation may wish to obtain or retire the interest of the second, older stockholder upon the latter's death. The older man, looking to continued participation in the business by the younger members of his family, may resist just such an agreement. Or the attitudes of the parties may be reversed. The older man may wish an assured market for his stock, while the younger lacks the financial resources to purchase it himself, and does not wish to burden the company with the obligation.

Once these different objectives have been reconciled, probably the most serious disadvantage of buy-sell agreements is their rigidity. Family attitudes, business circumstances or the governing law may change. For example, at the time of death, the company, due to unforeseen circumstances, may no longer have the necessary cash to carry out the agreement, or one family may no longer wish to sell or buy. While the agreement can, of course, be modified by mutual consent before it becomes operative by death, one or more parties may object to such modification, or mere inertia may leave it unchanged until its consequences become painfully apparent upon the death of a stockholder, at which time modification may be impossible. Although the parties can agree not to carry out the agreement even after it becomes operative, one of them may insist upon consummation without regard to the consequences to the other party. These painful consequences are well illustrated today by agreements created under the 1939 Code which have or may soon become binding upon the death of a stockholder, forcing with disastrous tax effects, a purchase under the new 1954 Code rules respecting stock redemptions and constructive ownership.

Because of these problems, all available variations and alternatives should be carefully considered before the parties enter into the usual binding agreement of purchase and sale.

If the primary goal is to provide stable income for the decedent's widow or children, while assuring the active participants in the business of the sole right to control and future capital appreciation of their stock, a complete buy-out may not be necessary. New classes of nonvoting or high par value stock or obligations may serve the desired purpose; their use can also avoid the need to raise funds on short notice, as might be necessary if stock were purchased for cash. Needless to say, these alternatives raise problems of their own.

If the real question is solely one of corporate control, particularly over a relatively limited period, a voting agreement may be the answer, thus avoiding either a buy-out or a reorganization.

In spite of its initial lack of attraction, a complete liquidation of the corporation may be in order. This is perhaps particularly true where successful operation of the business depends largely on the personal abilities and contacts of the active stockholder participants, and especially if two or more of the major stockholders die within a relatively short period. It might be possible to include a provision permitting rescission of the agreement, with or without

[1] Unless perhaps the proceeds of the first purchase are held in escrow, this may only be feasible where the price is paid largely in nontransferable notes, or in cash installments payable over a considerable period of time.
[2] Sections 301, 316, Internal Revenue Code of 1954. Unless otherwise indicated, subsequent statutory citations refer to this Code.
[3] Sections 531-537.
[4] Section 264(a)(1); Proposed Regs. Sec. 1.264-1.
[5] Paramount-Richards Theatres, Inc. v. Comm'r, 153 F.2d 602 (5th Cir. 1946). See also Thomas F. Doran, TC Memo. 1956-121, where the proceeds of the policy itself received dividend treatment.
[6] Reg. 105, Sec. 81.10(i)(1).
[7] Section 101(a).

such a liquidation, at the option of the survivors, if holders of a given percentage of the total outstanding stock should die within a stated period.[1]

In many instances, however, the buy-sell agreement may be the only method of solving the problem. Two types of buy-outs can be used. The stock-purchase agreement may be set up either in the form of a cross-purchase, under which the surviving stockholders agree to acquire the interest of the decedent directly, or as a stock redemption, whereby the corporation itself buys the decedent's shares. The tax and business effects of these two types of acquisition differ considerably.

Cross-purchase by stockholders

Probably the greatest advantage of cross-purchase agreements is that they avoid risks that amounts distributed by the corporation in redemption of its own stock will be taxed as dividends to the selling stockholders.[2] Advantages of generally lesser importance are that such agreements avoid the contention of unreasonable accumulation of earnings,[3] questions of corporate law which arise if the corporation itself acquires the decedent's shares, and other problems.

In many cases, however, it will be impractical for the stockholders to undertake to acquire the interest of the decedent because of the difficulty of financing the purchase. Generally the purchase price must come from after-tax dollars, whether they have been previously accumulated or are used to repay borrowings to make the purchase. This problem arises most frequently when the oldest stockholder, who often presumably will be the first to die, also owns the largest stock interest in the corporation.

While the purchase price may be obtained in whole or in part by means of life insurance, this method too presents problems. The cost of the insurance is nondeductible.[4] If the corporation pays the premiums, they may be treated as dividends to the stockholders.[5] One or more of the stockholders may be uninsurable, or under state law the other stockholders may lack an insurable interest in his life. If a number of stockholders are involved, each must carry a policy on the life of every other party to the buy-sell agreement, and the number of policies multiplies rapidly. For example, if there are only two stockholders, only two policies would be required, whereas if there are six stockholders, 30 policies may be necessary. This last problem is probably best avoided, at some additional expense, by the use of a trust.

When one of the shareholders dies, the policies he owns on the lives of the others are taxable in his estate at the amount it would cost to replace them.[6] If the surviving shareholders acquire those policies, they lose the benefit of nontaxability of the proceeds except to the extent of the sum of the consideration which they paid the decedent's estate, plus premiums and other amounts paid by them thereafter unless either the policy has a substantial basis or the transfer is to one of a limited group of persons, including the corporation but not the other parties to the buy-sell agreement.[7]

Redemption by corporation

More often than not the parties will find a corporate acquisition relatively more attractive than a cross-purchase arrangement, if for no other reason than that the purchase price can come from earnings which have been exposed to the single corporate tax only. On the other hand, a stock redemption will generally provide its share of difficult problems.

The most serious of these is the possibility that all or part of the proceeds of the redemption may be taxed to the recipient as ordinary dividend income. The redemption by a corporation of its own stock other than in liquidation[8] will be treated as a dividend to the shareholder to the extent of the corporation's earnings unless the redemption comes within the provisions of either Section 302 or Section 303.

Sale by estate to pay taxes

Section 303 was specifically designed[9] to permit an estate to sell stock to the issuing corporation as a sale transaction rather than a dividend. It is of no help in a buy-out resulting from retirement rather than death, and even in a buy-out from an estate, the benefits are available only in limited circumstances.

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The section is applicable only if the stock redeemed is included in the decedent's gross estate for Federal estate tax purposes. The value of the stock must be either more than 35% of the value of the gross estate or more than 50% of the value of the taxable estate.[10] Very frequently, of course, the stock owned is not sufficient to meet this requirement.

A second limitation permits redemption of only enough stock to pay the decedent's death taxes (state and Federal) and the deductible funeral and administration expenses,[11] and thus will often permit redemption of only a portion of the decedent's entire stock interest. Since the ordinary stock purchase agreement usually contemplates complete retirement, Section 303 is more generally useful in other estate-planning objectives, although it may also serve as partial protection under a buy-sell arrangement.

Three permitted redemptions

It will ordinarily be necessary for the buy-out to qualify in whole or in part as a redemption "treated as a distribution in part or full payment in exchange for the stock"[12] under Section 302(b) in order to avoid dividend treatment. To qualify, under this rule, the redemption must be either: (1) not essentially equivalent to a dividend; (2) "substantially disproportionate" within the statutory definition of that term; or (3) in complete redemption of all of the stock of the corporation owned by the shareholder.[13] Compliance with any one of these alternatives will suffice.

Whether a redemption is essentially equivalent to a dividend depends upon the facts existing at the time of the redemption. Unfortunately the guides for qualification under this provision are so vague as to make it extremely difficult to determine whether a particular redemption will meet the test.

The Senate Committee Report[14] indicates an intent to carry forward in this provision the concepts of dividend equivalency developed by the case law under Section 115(g) of the 1939 Code. However, these cases viewed the problem as a question of fact,[15] and no one

[8] Or in partial liquidation under Section 346.
[9] Revenue Act of 1950; House Committee Report, pp. 63-64; Senate Committee Report pp. 54-55.
[10] Section 303(b)(2)(A). If more than 75% in value of the stock of each of two corporations is included in determining the value of the decedent's gross estate, stock in the two corporations is considered as stock in a single corporation for the percentage tests. Section 303(b)(2)(B).
[11] Section 303(a). Interest is also included if collected as a part of such taxes.
[12] Section 302(a).
[13] Section 302(b)(1), (2) and (3). Section 302(b)(4) adds a fourth test applicable to certain railroad Bankruptcy Act reorganizations.
[14] pp. 44-45, 233.
[15] E.g., Flanagan v. Helvering, 116 F.2d 937, 1940.

factor was ordinarily determinative. The courts did not develop any yardstick against which a redemption can be measured. Additionally, because many of the situations that qualified as redemptions under old Section 115(g) are now covered by other specific provisions of the 1954 Code, there is increasing doubt about the area in which Section 302(b)(1) is operative.[16] Further the application of the constructive-ownership rules of Section 318 (discussed below) make reliance upon this section even more hazardous.

Although Section 302(b)(1), the not-essentially-equivalent rule, may rescue a poorly conceived stock purchase agreement, this section should not be relied upon in planning such a transaction.

Substantially disproportionate

The other two of the three shelters provided by Section 302 involve purely mechanical tests and apparently can be relied upon in planning. The first is the "substantially disproportionate" stock redemption as defined in Section 302(b)(2). Although developed to a great extent from the case law under Section 115(g) of the old Code, the requirements of the new statutory definition, while having an advantage of certainty, are considerably more difficult to meet.

For a redemption to qualify, the shareholder whose stock is redeemed must own, immediately after the redemption, less than 50% of the total voting power of all classes of stock entitled to vote; and his percentage ownership of common stock and voting stock immediately after the redemption must be less than 80% of that same percentage immediately before the redemption. If the decedent's estate, for example, owned 60% in value of the total voting stock of the corporation immediately before the redemption, it must have something less than 48% of such stock immediately thereafter.

Reliance upon the protection of the substantially disproportionate rule can lead to any of three dangers.

The first is Section 302(b)(2)(D), which provides that the substantially disproportionate rule will be inapplicable if the redemption is pursuant to a plan, the purpose or effect of which is a series of redemptions which in the aggregate are not substantially disproportionate. Usually a stock-purchase program applies to most if not all of the stockholders. It is not inconceivable that the effect of such a program when applied to two or more buy-outs can be such that the earliest buy-outs, substantially disproportionate when they occurred, can lose that status by reason of the later redemptions. It is not fantastic to anticipate that an agent, examining such a buy-out, will see a sinister "plan" within the scope of Section 302(b)(2)(D).

A second danger lies in the provision of the Regulations[17] that Section 302(b)(2) does not apply to any redemption *solely* of nonvoting stock, either common or preferred. If solely nonvoting stock is involved in the buy-out, the redemption to be treated as a sale or exchange must qualify either under the vague not-essentially-equivalent test of Section 302(b)(1), or as a complete redemption under Section 302(b)(3). However, a redemption which does involve voting stock and which qualifies as substantially disproportionate under Section 302(b)(2) will also provide exchange treatment for a simultaneous redemption of nonvoting preferred stock (other than Section 306 stock) or nonvoting common stock.

The third, and perhaps major, danger in the substantially-disproportionate rule lies in the application of the constructive-ownership rules of Section 318. Since these rules apply to complete redemptions also, they are discussed later.

Termination of interest

Mechanical shelter is also found in Section 302(b)(3) which provides that the redemption will be treated as a sale or exchange if as a result the corporation acquires all of the stock of a shareholder. Again, the constructive-ownership rules are applied to determine ownership and may result in making a complete redemption impossible.

Under Section 318, an individual is treated as owning stock owned "directly or indirectly" by his spouse, children (including adopted children), grandchildren, and parents, generally referred to as family ownership. He is also treated as owning a proportionate interest (variously computed) of stock owned by partnerships of which he is a member, by estates or trusts of which he is a beneficiary, or by other corporations in which he has a 50% or greater interest. In addition, these partnerships, estates, trusts (with a limited exception) or corporations are treated as owning in their own name all stock owned actually or constructively by their partners, beneficiaries and 50% stockholders. Through this chain, an individual can be treated as owning stock actually owned by one with whom he has no direct connection, e.g., his partner's wife's father's estate. An option to acquire stock is also treated as ownership.

In short, an endless attribution of stock ownership is possible. The not in frequent result is that every stockholder in the corporation is treated as owning 100% of its stock. The Code makes only one exception to continued reapplication of constructive ownership. If stock is treated as constructively owned by an individual through application of the family-ownership rule, the constructive ownership is not treated as actual ownership for purposes of further attribution under the *family* rule, although it is so treated for purposes of attribution under the rules relating to partners, estates, trusts, corporations and options.[18]

While the Regulations make some attempt to limit the effect of these constructive-ownership rules, it will take years of litigation or else repeal before their effect is completely predictable. In the meantime, however, these rules are to be used in every case where it is necessary to determine the ownership of stock in applying the tests of Section

tax problems?

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[16] While Section 302(b)(5) provides that failure to meet the other tests under Section 302(b) is not to be taken into account in determining the application of Section 302(b)(1), this has not resolved doubts as to what *is* to be considered.
[17] Regs. Section 1.302-3(a).
[18] Section 318(a)(4)(B). However, if stock may be attributed both under the family rule and the option rule, attribution is deemed to occur under the latter rule only, so that further constructive ownership under the family rule is possible. No mention is made of cases in which both the family rule and some rule other than the option rule are applicable.
[19] If the distribution is treated as a dividend, Regs. Section 1.302-2(c) provide for "a proper adjustment to the basis of the remaining stock." Problems involved in this adjustment are discussed in Brodsky and Pincus, *The Case of the Reappearing Basis*, 34 TAXES 675 (1956).
[20] Section 302(c)(2), 302(b)(5).
[21] KOMA, Inc. v. Comm'r, 189 F.2d 390 (10th Cir., 1951).
[22] Gazette Publishing Co. v. Self, 103 F. Supp. 779 (DC Ark., 1952). Cf. The Emeloid Co., Inc. v. Comm'r. 189 F.2d 230 (3d Cir. 1951); General Smelting Co., 4 TC 313 (1944) acq., 1945 CB 3; Dill Manufacturing Co., 39 BTA 1023 (1939) non-acq., 1939-2 CB 47.

302 to ascertain if a redemption is to be treated as a sale or exchange or as a dividend distribution.

The constructive-ownership rules constitute perhaps the greatest single stumbling block to the buy-sell agreement. Although there are many examples of such serious pitfalls, the most common occurs in the one-family corporation in which some stock is owned, even if only in dribs and drabs, by most or all of the family members. Of course, the wife or children, or both, are the beneficiaries of father's estate. Upon his death, and prior to the distribution of his estate, all the stock owned by the family will be attributed to the estate, since the beneficiaries either are all of the other stockholders or constructively own all of the remaining stock.

Only if stock owned by the estate can be redeemed under Section 303 (a redemption to pay death taxes) can an ordinary dividend to the estate to the extent of the corporate earnings be avoided.[19]

Some relief from this harsh treatment may be found in Section 302(c) if all of the stock of the estate is redeemed. Under the complete-termination-of-interest rules, the family-ownership rules will apply, in a very complex way, under certain very limited circumstances.[20] Even if they are applicable (an unlikely circumstance), the provision's effect is to prevent the stock of some family members being attributed to others and thence to the estate. The provision will not prevent attribution of a beneficiary's stock directly to the estate.

Other variations of the constructive-ownership pitfall can occur when either or both members of a two-man corporation spread their stock among their families. The same danger exists if the corporation has ten stockholders. Each situation is, of course, different, and each agreement must be tailored to the particular facts involved. Generally, with care, an agreement can be written that will solve the problem under the situation existing when the agreement is prepared. The danger lies in not keeping the agreement current when the facts or the law change.

One method of avoiding this danger is to eliminate the basic difficulty—the rigidity of the agreement. Frequently this can be done by making the agreement a put or a call rather than a binding contract. Thus, if the purpose of the agreement is to benefit members of the family of a decedent, giving them a put, to exercise or not, may be advisable, although in a given case this method too may raise problems. If the purpose is to protect the corporation, it should be given a call to exercise if its circumstances permit. In the latter instance, additional protection against a disastrous tax result might be provided the stockholder by giving him and his family a put as to the balance of their stock, exercisable if the corporation exercises its call.

One corporate-stock-acquisition problem which, as previously noted, is avoided by cross-purchase arrangements is the danger of attack under the accumulated-earnings-tax provisions—formerly Section 102 (now 531). The IRS has successfully advanced the argument that the use of corporate funds for the purpose of retiring stock of a shareholder reflects an accumulation beyond reasonable business needs.[21] While the case law falls far short of condemning stock redemptions generally as proof of an improper retention of earnings, and there is in fact some precedent tending to approve accumulations for this purpose,[22] this factor should be taken into consideration if a prosperous family business has reason to doubt the safety of its dividend policy on other grounds. In this connection the new minimum $60,000 accumulated-earnings credit,[23] the recognition that the proper needs of a business include those needs reasonably anticipated,[24] and the provisions permitting the taxpayer to shift the burden of proof to the Commissioner[25] may be helpful.

While tax and business requirements receive primary emphasis in most buy-sell agreements, corporate law cannot be ignored. Under most modern statutes a corporation may acquire its own shares, but this may not be so in all states. Where it is permissible, payment must ordinarily be made from earned surplus or its other statutory equivalent. Since this surplus may be dissipated at some future date, the corporation may be unable to perform the agreement. Perhaps the best practical answer to this problem may be a provision obligating the corporation to use its best efforts to retain the necessary surplus.

Another consideration where the stock-purchase price is largely covered by insurance is the possible windfall which may result to the survivors if the decedent dies soon after the policies are taken out. For example, assume that a corporation worth $300,000 is owned equally by two stockholders. The corporation carries $100,000 insurance on the life of each stockholder. If one stockholder dies shortly after the insurance is taken out, his estate must receive roughly $200,000 for its stock to obtain 50% of the value of the corporation, rather than the $150,000 to which it would be entitled if the agreement looks solely to the value of the corporation immediately before his death.[26]

Purchase agreements intended to control stock valuations for estate tax purposes present some special problems. If the agreement is to control estate tax value, the decedent's estate must be unconditionally committed to sell at the agreed price.[27] This agreement should be specifically enforceable.[28] The purchaser, however, probably needs only an option to purchase.[29] Such an option may control estate tax valuation even if it is not actually exercised.[30]

In addition the decedent should be prohibited under the agreement from realizing an amount in excess of the buy-sell price by a disposition during his life.[31] The same restriction should apply to his donees.

Since a low value obviously is desirable, agreements of this sort are usually confined to situations in which the purchaser (or its stockholders, if purchase by the corporation is contemplated) is within the family of the decedent.

The ordinary absence of an arm's-length relationship between the parties has also caused the Service to scrutinize these agreements carefully at least where the decedent's stock was originally acquired free of restrictions.[32] For this reason, while the Federal[33] decisions to date are favorable, the sale price should bear some fair relationship to the estimated value of the stock, and the purchaser should not be a beneficiary under the will of the decedent. ☆

[23] Section 535(c).
[24] Section 537.
[25] Section 534.
[26] See Appleman, *A New Approach to Buy-and-Sell Agreements*, 30 TAXES 821 (1952).
[27] While a price provision effective only in the event the stockholder wishes to sell will not determine estate tax value, it may have some depressing effect. Worcester County Trust Co. v. Comm'r, 134 F.2d 578 (1st Cir., 1943). Rev. Rul. 189, 1953-2 CB 294.
[28] While this is not clearly a requirement, it has been relied upon in some of the cases, e.g., Wilson v. Bowers, 57 F.2d 682 (2d Cir. 1932); Lamb v. Sugden, 82 F.2d 166 (2d Cir., 1936).
[29] E.g., May v. McGowan, 194 F. 2d 396, 1952.
[30] Wilson v. Bowers, supra, n. 28; Comm'r v. Child's Estate, 147 F.2d 368 (3d Cir. 1945). I would question the wisdom of relying, however, on these cases.
[31] Estate of Lionel Weil, 22 TC 1267 (1954) acq. 1955-2 CB 10; Estate of George Marshall Trammell, 18 TC 662 (1952); Estate of James H. Matthews, 3 TC 525 (1944); Rev. Rul. 157, 1953-2 CB 255.
[32] Rev. Rul. 54 77, 1954-1 CB 187; Rev. Rul. 54-76, 1954-1 CB 194.
[33] State courts have often refused to be bound by such agreements for inheritance tax purposes.

TAX ASPECTS OF ESTATE PLANNING

Estate & gift taxation

OF INTEREST TO TAX PRACTIONERS

Tax procedures for the executor; a check list of returns, elections, liabilities

by **BYRON E. BRONSTON**

A most important duty of the executor is to prepare, file and settle the tax problems of the decedent and the estate. He must file numerous notices and returns, amass considerable data, consider the possibilities of additional assessments, and never lose sight of the chance that he might be charged with personal liability. The omission of any step can have dire consequences to either himself, or the beneficiaries. To thwart that possibility, Mr. Bronston drew up this excellent and complete check list, which was originally published in the Chicago Bar Record, and which he adapted for publication here.

EVEN AS DEATH and taxes are certain, so are the tax problems confronting an executor. They begin immediately upon the death of the decedent. Both the executor and the attorney for the estate must, even before the will is admitted to probate, give consideration to some of them. Careful planning early in the period of admission often results in a saving of income, inheritance, and estate taxes.

Schedule of tax steps

Even before appointment by the Court:

(1) Approximate the amount and location of both real and personal property and determine if any property was held in joint tenancy.

(2) Collect the data for the income tax return of the decedent to the date of death; obtain copies of the decedent's income tax returns for at least the last three years and the records in support of the returns.

(3) Determine whether the decedent was covered by the Social Security Act, and, after appointment, write the Social Security Administration about any benefits due the estate or beneficiaries.

(4) Ascertain the status of both real estate and personal property taxes on the property of the estate.

(5) Find out if any gifts or transfers were made by the decedent for which gift tax returns were or were not filed, the date and value of any gift, and the name of the donee.

(6) Ascertain whether the decedent possessed a power to appoint by will, deed or other disposition, whether the power was exercised, and if so, the value of the property covered by the power.

(7) Inquire into the decedent's liability for social security taxes on domestics, and the estate's liability for employees retained by the executor.

(8) Arrange with the state officials for the examination of the contents of any safe deposit box standing in the decedent's name.

Preparing the estate tax return

After receiving appointment:

(1) Procure separate consents from the Inheritance Tax office for each bank account standing in the decedent's name, each holding of registered securities and each safe-deposit box.

(2) Obtain inheritance-tax waivers or consents from states other than the one of residence for each holding of a registered security if a consent is required.

(3) If there was insurance on the life of the decedent, consider obtaining a photostatic copy of each policy of insurance, and obtain from each company Federal Estate Tax Form 712 on each policy whether payable to the estate or others.

(4) Arrange to obtain from the beneficiaries of policies their contributions toward payment of the Federal estate tax unless the contributions are waived by the will.

(5) See that any real estate is appraised for inheritance and Federal estate tax purposes, and determine how much of the appraised value is allocable to land, to improvements and, if there is farm property, to growing crops. At the same time, have all personal property appraised.

Within 60 days after letters have issued:

(1) File with the Director of Internal Revenue Preliminary Notice Form 704 if the gross estate is expected to exceed $60,000 in value. If the tangible personalty of the decedent is of substantial value and if distribution or sale is to be made before examination of the Federal estate tax return by the agent of the Internal Revenue Service, Regulation 105, Section 81.10(g) provides a means whereby a consent may be obtained.

Twelve months after death:

(1) Determine whether to value the estate for Federal estate tax purposes at the value as of the date of death or, as permitted under Section 2032, as of one year after death. The return must be filed within 15 months after the date of death.

(2) Upon filing the return, request, as provided in Section 2204, that the amount of the estate tax be determined within one year after the request and that the executor be discharged from personal liability therefor.

(3) Further, prepare the deduction for estate tax on accruals (income in respect of a decedent) as provided in Section 691(c), and consider amending income tax returns filed for accrual deductions (Sec. 691(b)) and optional values if the estate tax return was filed using the alternative valuation of one year after death.

(4) Consider using the deduction of administration expenses on income tax returns as permitted by Section 642 (g).

(5) After the estate tax examination has been completed and any deficiency in tax or overpayment has been determined, consider the effect of any change in valuation of assets. Such changes affect the basis for gain or loss in the future and may affect changes on in-

come tax returns filed by him as to capital gain or loss and as to deductions for accruals.

(6) When filing the estate tax return and paying the tax, it may be possible to use certain U. S. Government bonds to pay the tax. If so, the bonds should be tendered for such payment one month before the tax is due. With these bonds, definite tax advantages are obtainable. [See 5 JTAX 329. *Ed.*]

Income tax returns of estate

(1) As each fiduciary return is filed for the estate, make a request for its prompt examination, pursuant to the provisions of the same section of the Code. The request shortens from three years to 18 months the time within which a determination must be made by the Internal Revenue Service.

(2) When preparing to file the first fiduciary return, consider the desirability of placing the estate on a fiscal year. Once the basis is chosen, it must be followed. Therefore before deciding to go on a fiscal-year basis, carefully weigh the apparent advantages that might arise early in the administration of the estate in either the matter of the receipt of income or the taking of deductions, and the effect of a fiscal-year period late in the administration and the time of distributing and closing the estate.

(3) Annually, probably late in the year, consider the advisability of distributing some income to legatees, or beneficiaries, and of using some of the administration expenses and fees as an income tax deduction, as permitted by Section 642(g), in lieu of estate tax deductions under Sec. 2053. If a portion of the estate is bequeathed for a charitable purpose, the estate will claim as a deduction a proportionate part of taxable net income. If a bequest of a specific amount is satisfied by delivering securities in lieu of cash, capital gain or loss on the securities must be reported on the fiduciary return of the estate. If income is being distributed to a nonresident alien, withhold an amount equal to 30% thereof to pay the nonresident alien tax, as provided in Section 1441.

(4) When preparing the final accounting for filing in the Probate Court, ascertain whether all state inheritance taxes, Federal estate tax, personal property taxes, and income taxes have been finally determined and paid or provided for. In the year of termination of the estate, there may be a net operating loss carryover under Section 172 or a capital loss carryover under Section 1212, or, for the last taxable year of the estate, certain deductions in excess of gross income for such year which may be taken on the last fiduciary return as a deduction and passed on to the beneficiaries succeeding to the property of the estate as provided in Section 642(h).

(5) Upon making distributions of the estate, inform the residuary legatees of income and gain upon which they are taxable, and furnish them with the cost basis, as determined in the Federal estate tax proceeding, of securities or other property distributed to them.

(6) Pay out of the estate the Federal stamp tax on bonds, stocks and other securities subject to tax, distributed in kind, and have affixed the stamps as required by Section 4353. Other pertinent provisions of the Code with respect to documentary stamps may be found in Sections 4321, 4331, 4342, 4343, 4344 and 4351.

Executor's liability

The definition of a fiduciary under the Code includes executors or administrators. (Section 7701(a)(6)). The term "executor" wherever it is used in the estate tax sections of the Code means the executor or administrator of the decedent; or if there is none appointed, qualified and acting within the United States, then any person in actual or constructive possession of any property of the decedent. (Section 2203.) The personal liability of an executor may result from unpaid income tax assessments issued against the decedent or the estate, from the unpaid estate tax of the decedent, or from the unpaid gift taxes of the donor (Section 6901, and Section 3467 of Revised Statutes, 31 USC 192). Notice to the Secretary or his delegate of the assumption of a fiduciary relationship and later that the fiduciary capacity has terminated are provided by Section 6903. Once the executor has given notice of his discharge, he has no further authority to represent the estate as to tax matters. The Supreme Court ruled, in the case of *Hulburd v. Comm'r*, 296 U.S. 300, that the fiduciary capacity, however, must have terminated under state law or the notice is not effective.

It is the duty of the executor to examine the returns of the decedent which had been filed prior to the date of death and to make some reasonable check between the assets in the estate and prior income tax returns. A correlation of the two may make it obvious on the usual "net worth" basis that the decedent had failed to report part or all of the income from his assets. An executor owes an obligation both to the Government and to the estate to disclose the facts through the preparation and filing of amended returns, in so far as it may be possible to prepare such returns, if an examination of the facts leads the executor to feel reasonably sure that false returns may have been filed by the decedent. There is no way in which the executor may terminate his responsibilities for penalties that might be imposed with respect to false returns.

Section 81.99 of the estate tax Regulations provides that if the executor, before paying all the estate tax, pays in whole or in part any debt due by the decedent or the decedent's estate, or distributes any portion of the estate, he is personally liable to the extent of such payment or distribution for so much of the estate tax as remains due and unpaid. The income tax Regulations state with respect to returns filed by the executor that the liability for the payment of the tax attaches to the person of the executor up to and after his discharge if prior to distribution and discharge he had knowledge of his tax obligation or failed to exercise due diligence in ascertaining whether or not such obligation existed. The Tax Court has held that both the Administratrix and distributees were liable for deficiencies and additions to tax for their failure to file a return and negligence determined on unreported income of the decedent, since the administratrix made distribution of the estate with notice of unpaid taxes (*Viles*, TC Memo 1955-142).

Income tax return

The first return to be filed by the executor in the usual case is that of the decedent to the date of death.

Besides obtaining copies of the last income tax returns and working papers of the decedent, the executor should obtain W2 and 1099 forms from the decedent's employer—if he had one. He should also consider filing the return to the date of death jointly with the surviving spouse. This return is due no later than 3½ months after the close of the decedent's taxable year. If a joint return is filed, the tax and credits should be allocated between the estate and the spouse. Upon filing the return to the date of death, a request for examina-

tion of this return and all prior returns of the decedent not barred by the running of the statute of limitations should be made as provided by Section 6501(d) of the Code.

If the executor decides to file a joint return, he must consider possible adjustments between the estate and the spouse in the event a deficiency is subsequently determined. If the executor joins in the filing of a joint return under which the benefits of any tax savings flow primarily to the spouse, there is always the possibility that those interested in the estate may be damaged unless the estate pays no more than its tax would have amounted to had the executor filed an individual return.

If the decedent was a member of a partnership, under Section 706 of the Code the partnership's taxable year will usually not terminate with the death of the decedent nor will the partnership income of the decedent, beginning with the close of the last previous taxable year of the partnership, be returnable in the decedent's return to the date of death. Rather the decedent's share of partnership income for the year in which he dies, determined in accordance either with the agreement or applicable law, will be determined as of the close of the partnership's taxable year and will be returned by the executor in the year in which payment is received. Such income to the date of death is income in respect of a decedent (Section 753). If, however, the decedent was a member of a two-man partnership, the partnership agreement and local law should be studied carefully to determine if the partnership has in fact terminated and the taxable year of the deceased partner will have ended with his death, thereby causing his share of the income of the partnership to be included in the decedent's return to the date of his death.

tax problems?

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Under Section 213(d), expenses for medical, dental and similar items may be taken as a deduction on the return to the date of death if they are paid out of the estate within one year from the date of death and are not deducted for estate tax purposes.

A question that arises occasionally when the decedent has been a beneficiary of trust income is whether his income from the beginning of the trust's taxable year to the date of his death is to be determined in accordance with the Section 706 principles applicable to the year in which a deceased taxpayer's income is taxable. The argument has been strongly advanced that if a trust and a decedent-beneficiary are on a calendar year, the income to the date of decedent's death is taxable in the executor's fiduciary return for the year in which such income is received, the amount of the distributable net income to be taxed not being determined until the close of the trust's taxable year. The Commissioner has undertaken to clarify this point in Section 1.662 of the final Regulations. He has ruled that "the gross income for the last taxable year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under Section 691.

If the decedent was a cash-basis taxpayer, the final return until the date of death will include income actually or constructively received during the period of his lifetime. It will not include such items as are accruals or accrued rights to income. This class of income is includible in the Federal estate tax return; it is returnable under Section 691(a) in the executor's fiduciary return in the year in which it is received and is entitled to a deduction on the income tax return for the amount of estate tax attributable to it (Section 691(c)). If such income in respect of a decedent is not received by the executor but is distributed, the legatee or beneficiary receiving it will report it in the year in which it is paid and will likewise be entitled to the deduction under Section 691(c). Examples of income in respect of a decedent are accrued interest on bonds and other obligations; salary and wages actually earned; dividends declared to stockholders of record of a date prior to date of death; bonus and other compensation payments made in consideration of personal services rendered by the decedent; income realized from a claim which was in the process of litigation at the date of death; and deferred income from transactions which were consummated during the decedent's life.

Accrued deductions are entitled to the same treatment as accruals of income. They are listed in Section 691(b). An example within Section 691 may be that of a cash-basis decedent who, the owner of a sole proprietorship, has directed by his will that his executor continue the business. The accounts receivable will be inventoried as separate assets of the estate as will the business inventory, cash and other property used in the conduct of the business. The accounts payable are claims against the estate and deductible as such on the estate tax return. They will also be deductible on the executor's return as business or trade expenses and are undoubtedly Section 691(b) deductions whether or not there is income returnable under Section 691(a). If the executor must take long-term capital gain into account in computing gross income in respect of a decedent, 100% of it will be taken and the same percentage will be used in computing the deduction authorized to recipients of income in respect af a decedent by Section 691(c).

Elective deductions

Administration expenses, including the executor's and attorney's commissions and fees, are deductible on the Federal estate tax return under Section 2053. Certain losses are deductible under Section 2054. To the extent that these items of deduction can qualify as deductions from gross income under Section 162 (trade or business expenses), Section 165 (losses not compensated by insurance or otherwise), Section 212 (expenses for production of income), they may be used by the executor as deductions on the fiduciary income tax return of the estate in lieu of being used on the estate tax return. They cannot be used as double deductions. Their use wisely on one return or the other will often effect substantial tax savings to the estate. To the extent that they may be used as an income tax deduction in the year of closing the administration, they may be passed on to the distributees of the estate and be availed of by them on their individual returns. Sec. 642(g) and Sec. 642(h) are the pertinent sections of the Code.

The Regulations provide that amounts may be deducted under Section 2053 (estate tax) as claims against the estate if they represent personal obligations of the decedent existing at the time of his death. If a divorced wife files against the estate a claim for alimony, which is allowed by the probate court, it would seem that such a claim, to the extent that it would be deductible from the gross income of the estate under Section 215 would fall within the election allowed under Section 642(g). If alimony is payable by the estate for a period after death as a charge upon corpus, it has been held that the payments are taxable to the wife under Section 71. Since under the foregoing circumstances the wife would be taxable upon the payments received from the estate, it should be permitted to claim them as an income tax deduction under Section 215 if the provisions of Section 642(g) are complied with by the executor.

If fees and administration expenses are used as income tax deductions under Section 642(g) and if there is a marital deduction, the estate tax will be larger and the adjusted gross estate for determining the amount of the marital deduction will likewise be larger. This result may operate to the disadvantage of the residuary legatees. The question has been raised with the Commissioner as to whether or not the taking of such deductions on the income tax return will still permit them to be used in determining the size of the adjusted gross income for marital deduction purposes. The Commissioner ruled on this question in *Rev. Rul.* 55-643. Where the decedent bequeathed to his wife an amount equal to 50% of the value of his adjusted gross estate as finally determined for Federal estate tax purposes, less the aggregate amount of other property which passes to her and qualifies for the marital deduction, this being a formula type of bequest, the executors elected to claim certain expenses of administration as deductions from the gross estate under Sections 162 and 212 rather than as estate tax deductions under Section 2053, the election being made under Section 642(g). The Commissioner held that where amounts allowable under Section 2053 are claimed as deductions for income tax purposes under Sections 162 or 212 and the right to have them allowed as deductions for estate tax purposes is waived, such items do not constitute deductions allowed by Sections 2053 or 2054. Section 642(g) is a limitation upon the two estate tax sections. The Commissioner ruled that, upon the statement of facts, the value of the adjusted gross estate is determined by subtracting from the gross estate only the deductions authorized by Section 2053 which are actually allowed as deductions for estate tax purposes. (See *Rev. Rul.* 55-225.) The value of the interest which actually passes to the surviving spouse should not be reduced by the amounts of those items which are not allowed as deductions under Section 2053.

How does an executor avail himself of the right to take estate tax deductions as income tax deductions as permitted under Section 642(g)? He must file a statement to the effect that the items have not been claimed or allowed as deductions from the gross estate of the decedent and a waiver of the right to have such deductions allowed. But he may hold off for the full period of limitation before filing a waiver of his right to deduct administration expenses on the estate tax return. He may file the estate's income tax return without claiming the deductions, and at a later date claim them. He may claim the deductions on the estate's income tax return without filing the waiver when the return is filed. But he must file the waiver before the period of limitation has run on either the income tax or the estate tax return and before there has been a final determination of either tax. Once the waiver has been filed (to claim the deductions on the income tax return) it cannot be revoked in order to claim the estate tax deductions. (*Rev. Rul.* 53-240).

The duty of an executor is not only to administer the estate well but to minimize to the extent proper the multitude of tax burdens which fall upon the estate. He is, under court decisions, presumed to know the duties imposed upon him under the applicable tax statutes. ☆

New estate & gift decisions this month

Bequest to corporation for employee welfare fund is charitable contribution. [*Non-Acquiescence*] Decedent's will left income to his wife for life, with power to invade to maintain her standard of living, remainder to the Board of Directors of a private corporation with which decedent had been associated, to provide a retirement or welfare fund for the employees. The Tax Court held this was a charitable bequest. The amount of the remainder was not indefinite because the possibility of invasion by the wife was remote. *Carlson Estate*, 21 TC 291, *non-acq.* IRB 1956-46.

Trust to support children not in husband's estate. [*Acquiescence*] Pursuant to a separation agreement, decedent set up a trust, the income from which was to support his wife and minor children. The Code provides for the inclusion in the estate of property transferred (except for full consideration) if the decedent retained an interest in it for a period which does not in fact end before his death. Taxpayer-estate conceded that at decedent's death the trust income was still being paid over to his wife in discharge of the decedent's continuing legal obligation to support her and the children. Thus he still had an interest (in that his obligation was being met by the trust). The court held that this interest lasted for a period which literally did "not in fact end before his death." Turning to the question of consideration for the creation of the trust, the court pointed out that the Code states that the release of the wife's support rights is not to be deemed consideration. However, the part of the trust property referable to the support of the minor children was given in consideration for decedent's release from the obligation and is not includible in the estate. *McKeon Estate*, 25 TC 687, *acq.* 1956-47.

Securities in Europe during war valued below U. S. quotations. [*Acquiescence*] Decedent, a nonresident alien, died in Holland in 1943. The Tax Court held that securities which he owned and which were physically located in Holland at the time of his death and subject to wartime restrictions, were valued substantially less than the market value of comparable unrestricted securities

Notes on new estate and gift decisions in this department are by Theodore Berger, LL.B., CPA, who practices in Chicago.

being freely sold in the U. S. on that date. Failure to file an estate tax return until six years after decedent's death was held due to reasonable cause because of the difficulty of determining the tax status of "stiftungs," foreign personal trusts he had created and which the Tax Court held were includible in his estate. *Swan Estate,* 24 TC 829, *acq.* IRB 1956-47.

No partnership income to estate. [*Non-Acquiescence*] Decedent was a member of a partnership whose year ended January 31. He died November 21, 1947. The partnership agreement provided that if both partners survived the partnership year, each was to receive half the profits after partners' "salaries" as his distributive share; if one died during the year, his distributive share was to be limited to the "salary." For estate-tax purposes, he never had more than a potential right to profits in excess of his "salary," and as his death prevented that right from maturing, no interest in the earnings of the partnership to date of death in excess of his salary was includible in his gross estate. Life insurance taken out by and payable to the partnership on his life was not taxable in the estate, as he in his individual capacity had no incidents of ownership in the policies. *Estate of Knipp.* 25 TC No. 24 *non-acq.* IRB 1956-47.

Bequest to wife was unconditional; marital deduction allowed. Decedent's will provided that the portion bequeathed to his wife should pass to his children if she died before his estate was distributed. In a state-court action, the bequest to the wife was determined to be conditional not upon her surviving to the time of distribution, but upon her surviving the testator. The Federal court agrees with this interpretation, thus qualifying the bequest for the marital deduction. *Steele Estate,* DC Mont., 10/23/56.

Power of appointment was limited, not general; exercise doesn't put it in holder's estate. [*Acquiescence*] Under a trust created by their aunt, decedents each had a power to appoint their share of the trust in favor of their issue or surviving spouse. This power, which was exercised, was admittedly not a general power of appointment, standing by itself, so as to require upon exercise the inclusion of the trust share in decedent's gross estate. However, the aunt's trust further provided that if this limited power were not exercised the share would pass as provided in decedent's will. The Commissioner contended that this made the power a general one and included the trust share in the gross estate. The Tax Court did not agree, pointing out that the decedents still did not possess rights equivalent to the statutory definition of a general power and that moreover it was not exercised. *Chisholm Estate, Brown Estate,* 26 TC No. 30, *acq.* IRB 1956-46.

Property previously taxed is value less unpaid taxes. Peter and Thomas, brothers, were joint tenants in property valued at $1,200,000. Thomas died a year after Peter, and Thomas' estate paid the estate taxes on the jointly owned property on behalf of Peter's estate. Thomas' estate contended the property previously taxed should be computed without reduction for these estate taxes because the property was in fact received by the second decedent before estate taxes had been paid. The court, however, requires that the deduction be computed by reducing the gross value of property received from the first decedent (Peter) by any estate taxes on this property ultimately payable on behalf of Peter's estate. After reviewing the conflicting cases on this problem, the court holds that, despite the statutory references to property included in the gross estate of the first decedent, the property *received* by the second decedent was its net value after debts then unpaid. *McDonough Estate* (Bank of America, Ex'r), CA-9, 10/26/56.

Commissioner allowed interest as partnership expense; it therefore reduces partner's estate. [*Non-acquiescence*] Decedent was a member of a partnership which was permitted to deduct, in its year ended January 30, 1947, interest on a renegotiation settlement reached in 1951. However, for the purpose of valuing the partner's interest in the partnership as of the date of his death in 1947, the Commissioner argued that this accrued interest should not be deducted. The Tax Court said that the income tax determination implied that the liability was in existence at the date of death and that it reduces the value of the estate. *Knipp Estate,* 25 TC 153, *non-acq.* IRB 1956-47.

Trust subject to invasion is gift of future interests. Taxpayer established a trust for the benefit of two minor grandchildren. A spendthrift provision prohibited assignment of the interests in corpus or income. The trustees had sole discretion to invade corpus for either, but the remaining corpus was to be divided equally when the younger beneficiary reached age 21, without regard to previous advancements. Under this trust, the court holds immediate enjoyment by the beneficiaries is so circumscribed that neither has a present interest. Taxpayer cannot claim the $3,000 annual exclusion, the gifts being future interests. *Glenn,* DC S.C., 11/14/56.

Retained life interest valued by actuarial tables; cost of commercial annuity not proper measure. [*Certiorari denied*] Taxpayer created a trust of $100,000 providing for $400 monthly payments to him for life, remainder to his heirs. In valuing the remainder for gift tax purposes, taxpayer used the cost of a commercial annuity of $400 a month to value his interest; the cost being $93,000, he valued the remainder at $7,000. This court finds that other factors determine the cost of commercial annuities, and it approves the use of the annuity tables set forth in the Regulations. This ruling results in a valuation of $42,000 for the taxable remainder. *Bowden,* CA-5, 6/30/56, *cert. den.,* 11/19/56.

New trusts & estates decisions

Liquidation of trust not a taxable event. Taxpayer acquired her remainder interest in a trust, one-half upon the death of her father, and one-half upon the death of her mother. The trust properties were distributed to her upon the death of the life tenant. She claimed a loss at that time. The court holds the distribution is not a taxable event. In determining gain or loss on sale of this real estate, the basis to the taxpayer of property received because of the remainder interest from her mother is fair market value at the time of the mother's death because the property she received for this interest was held by the trustee

at the mother's death. The basis of property coming because of the remainder interest received under her father's will was cost to the trustee, since the property was purchased by the trust after her father's death. *Pierson*, 27 TC No. 34.

Gift to trust and license-back of patents upheld. At the same time a settlor turned over certain patent applications to family trusts, the trustees licensed him to use the patents at a stipulated royalty. The court finds the trusts and the assignment of the patents valid and irrevocable. Accordingly, income from the trusts is not taxable to the settlor, and he is permitted to deduct the royalties he had agreed to pay under the license agreement. *Potter*, 27 TC No. 21.

Grantor-life beneficiary not taxed on undistributed gains of trust. Taxpayer who was grantor, life beneficiary, and co-trustee of an irrevocable trust is not taxable on the nondistributable capital gains even though she had a limited right to invade corpus. After analyzing the trust indenture, the court says it is unable to conclude that "the benefits directly or indirectly retained by the grantor blend so imperceptibly with the normal concept of full ownership that the grantor after the trust has been established may still, for tax purposes, be treated as the owner of the corpus." *Solomon Estate*, 27 TC No. 47.

Grantor may be taxed if he adds to Clifford trust. The Code provides that income from a trust in which the grantor has a reversionary interest at death will not be taxable to the grantor merely because his life expectancy is more than ten years at the date of creation. Income from any property subsequently added to the trust will be taxed to the grantor if, at the time of the additional transfer, his life expectancy is less than ten years. *Rev. Rul.* 56-601.

NEW DECISIONS INVOLVING EXEMPT INSTITUTIONS

Tax exemption denied stock-car organization. The Service denies an exemption to an organization which promotes interest in stock cars and conducts stock-car races in cooperation with community organizations. The gross receipts from admissions are used to pay expenses; the excess it uses to distribute as prizes to winning members. [The Service holds that the organization deals with the public at a profit and that part of the profit inures to winning members.] *Rev. Rul.* 56-475.

Insurance club social, not business; taxable on dues. The court finds that the club was properly taxed on dues and initiation fees. The factors that showed it was social and not merely business were admission of guests including women, sales of liquor, card room, etc. *Insurance Club of Dallas*, DC Tex., 5/12/56.

Will rule on prohibited transactions if prospective or if return not yet due. The IRS national office will rule on transactions of exempt organizations and qualified employees' trusts falling under the prohibited-transactions rule if the transactions is prospective or if it occurred in a year for which a return is not yet due. If questions of value are involved, it will rule only if the value can be established without valuation or appraisals. However, no ruling will be issued on rental arrangements between the exempt institutions and the creator. *Rev. Proc.* 56-33.

Jockey Club not exempt; carried on substantial business. [*Certiorari denied*] Taxpayer was organized by breeders and racers of horses to control the industry. It maintains the records for and publishes a stud book, publishes a monthly racing calendar, licenses and disciplines owners, jockeys, etc. It collects fees for these services and for conducting races. Its net income in 1948 was $60,000 and its surplus over $700,000. The Court of Claims found that Congress did not intend to treat such an organization in the same way as a chamber of commerce or a board of trade, which are exempt. Taxpayer was performing services which well might have been done by others for profit or gain. *Jockey Club, cert. den.*, 10/8/56.

Exemption lost because of business activities. [*Certiorari denied*] Taxpayer was a trust which could have as beneficiaries only tax-exempt organizations designated by the trust grantor or his successors. The trustees had broad powers and, in addition to making the usual type of investment, profitably operated a hotel and three candy shops. Part of the trust income was actually distributed to charities. The Commissioner contended that the trust did not itself qualify as a charitable organization. In addition, he argued that the trust could not claim a deduction for its undistributed income. The Ninth Circuit agreed on both counts. Its commercial activities prevented a finding that the trust operated exclusively for charitable purposes. Nor could it, in computing its tax as a trust, deduct, as permanently set aside for charity, the undistributed income. This income, reinvested in businesses, was not used for charitable purposes exclusively. The one dissent pointed out that the majority are too narrow in defining "exclusively." The word is intended merely to exclude noncharitable beneficiaries. The deduction should be allowed for undistributed income. *Danz, cert. den.*, 10/8/56.

"I Am" foundation religious; expenses of staff reasonable; exemption allowed. [*Acquiescence*] Taxpayer-foundation was organized to propagate the teachings of the "I Am" Religious Activity. The court found this is a bona fide religious group. The fact that expense allowances were paid to the religious founder did not mean that any part of the earnings inured to the benefit of an individual. She and her staff devoted their entire time to foundation work, and the payment of living expenses instead of salary was reasonable because their mode of life was very simple. Exemption had been granted in 1939 but was revoked in 1945 when criminal fraud proceedings in the use of the mails was begun. The Commissioner assessed some $8,000 in tax, part of it for those years which were prior to 1945. *St. Germain Foundation*, 26 TC No. 80, *acq.* IRB 1956-43.

Exemption lost because of more than one exempt activity! One organization carried on two principal functions, each of which alone would have qualified for exemption under 1939 Code Section 101(9) and Section 101(10) respectively. As a unit, however, the organization was not tax-exempt because, the Tax Court held, its total activities could not qualify under either section. This court affirms. *Allgemeiner Arbeiter Verein*, CA-3, 10/13/56.

NEW DEVELOPMENTS IN

Foreign aspects of taxation

EDITED BY SIDNEY I. ROBERTS, LL.B., CPA,
JOHN COSTELLOE, LL.B., AND JOHN WILCOX, LL.B.

Virgin Islands "loophole" probably not so attractive as press reports suggest

PRESS REPORTS recently described a method of doing business in the Virgin Islands which they considered a major "loophole" in our tax law. A Democratic member of the House Interior Committee is stated as fearing that in opening the door a little bit "they may have taken off the whole side of the barn." The loophole is stated to be large enough so that a company like General Motors might be able to avoid its huge annual obligations to the United States tax collector merely by setting up a holding company in the Virgin Islands.

This state of affairs, is, of course, a result of a provision of a 1954 statute permitting tax exemptions to companies that set up new businesses in the Islands.

According to an official of the Department of Interior, the loophole would work as follows:

"A Virgin Islands holding company has two mainland subsidiaries, one in Pittsburgh for manufacturing, the other in New York for sales. The Pittsburgh company sells at cost to the holding company. The New York concern buys the goods from the holding company at the same price the New York company will eventually sell them for. Thus, the Pittsburgh and New York companies make no profits and pay no taxes. All the profits flow to the holding company, it pays taxes in the Virgin Islands, and promptly gets a 75% rebate."

Congressmen see no fraud

Various members of Congress indicate that this maneuver would not be fraudulent, but would merely constitute "finding a loophole in the law and taking advantage of it." The present law would grant new businesses in the Islands a subsidy, in effect an exemption amounting to 75% of the money paid to the territorial Treasurer as income tax. The same benefit would apply to stockholders receiving dividends, and partners receiving partnership profits. A 50% subsidy is available for profits from stock transactions. It is proposed to correct the situation complained of by providing that the subsidy will be limited to income actually earned in the Virgin Islands. To that end the corporation would not qualify for the exemption unless at least 80% of its gross taxable income from all sources, including dividends and interest, and at least 50% of its taxable income from sales is from sources within the Virgin Islands.

A Congressional spokesman indicates, however, that there is no "real rush" to change the law for the reason that "it is not yet well enough known to be attracting loophole-exploiters." This spokesman indicates that, while some tax lawyers have questioned him about the loophole, neither General Motors nor any other large corporation had made any move to set up shop in the Virgin Islands.

Is there really a "loophole"?

We readily share the conclusion of the Congressional spokesman, cited in the *Wall Street Journal*, that there is no need for any great hurry. In our judgment, the defects in the Virgin Islands' statute referred to by the Congressman as a "loophole" hardly exist and we would caution our readers to tread lightly in counselling anyone to try to plunge through. Section 482 of the Internal Revenue Code [which authorizes the Commissioner to allocate income and deductions among related enterprises in order to properly reflect the net income of each] seems to have been completely overlooked in the discussion of this "loophole." The *Asiatic Petroleum Case* 79 F.2d 234 (2nd Cir. 1935), *cert. denied*, 296 U.S. 645, decided under Section 45, 1939 Code (the forerunner of Section 482) demonstrates, we believe, an ample capacity on the part of both the Commissioner and the Courts to deal with any transaction of the kind described in the newspaper article referred to.

In that case the taxpayer sold at cost to a sister company which was a foreign corporation. The latter resold the securities abroad at a profit. The profit was taxed to the taxpayer, rather than to the foreign company, under the authority of Section 45. Applying the principle of this case to the "loophole" described above, it is difficult to conceive that the Commissioner would have any difficulty in allocating the profits of the Virgin Islands holding company to the Pittsburgh company.

Substance should control here

It seems to us also that even beyond Section 482, the courts would still have a weapon in striking down the transaction described as a "loophole". It is by now universally recognized that the tax law is concerned with matters of economic substance and that where a transaction is artificially arranged for purposes of tax avoidance, the courts will look to the substance of the transaction and disregard the form. In the light of this principle, it seems that the Commissioner will have available the additional argument that the intermediate sale from the Pittsburgh company to the Virgin Islands holding company was artificial and lacked business purpose, with the result that the transaction should be examined for its substance which, in effect, was clearly a sale by the Pittsburgh company to the New York company.

Moreover, the holding company would have to consider whether it is engaged in business in the United States by reason of these transactions and whether it realizes income from sources within the United States, in which event it would undoubtedly incur some United States tax.

It seems of interest to note also that if we were to agree that the malady with which the Virgin Islands' statute is said to be afflicted were to exist, the proposed medicine would probably not cure it. The holding company could

*See our discussion of this rule in 3 *Journal of Taxation* 43. See also 3 *Ibid* 113; 5 *Ibid* 111.

presumably arrange to have Virgin Islands' sales profits by having title pass in the Islands. [The title passage rule was recently reaffirmed in the Ballanovski case,* ... F.2d .. , 56-2 USTC Par. 9832 (2nd Cir. 1956)]. If the holding company refrained from declaring to itself any dividends from the United States subsidiaries, it would probably meet the gross income requirements of the proposed amendment. As indicated above, to the extent it has United States income, the Virgin Islands company would probably incur United States tax even under the present state of the law. It seems, therefore, that the reason for any lack of widespread use of the "loophole" is probably not that the tax bar is unaware of it, but, more likely, that it doubts its efficacy.

Other havens exist

Moreover, if the Virgin Islands company has no United States income, there is no special magic to the Virgin Islands. Panama, Lichtenstein, Liberia and other so-called tax-havens would serve the purpose with just as good tax results in the long run. ☆

New decisions

Exclusion for foreign income applies to overlapping 18-month periods. Taxpayer was abroad from July 1953 through August 1955, except for February 1954 and 1955. The entire period of 26 months thus includes two overlapping periods of 18 consecutive months, during which the taxpayer was physically present within a foreign country or countries for at least 510 full days. Consequently, income earned abroad during the period is excluded from U. S. tax. *Rev. Rul.* 56-487.

British firm using American broker not engaged in business here. A British corporation which engages an American broker to solicit orders in the U. S., and maintains a small stock of merchandise in a U. S. warehouse, does not engage in a trade or business in the U. S. "through a permanent establishment situated therein" within the meaning of the U.S.-U.K. treaty. Accordingly, profits on sales of merchandise here are not subject to tax. *Rev. Rul.* 56-594.

Not a foreign resident in year of death —not a 12-month period. Claiming refund of 1952 taxes applying to income earned after April 1952, counsel for taxpayer argued that the period January 1 to January 3, 1953 constituted a taxable year because taxpayer died on January 3. The exemption for foreign earnings applies if the taxpayer is a foreign resident for a period including an entire taxable year. The court holds that Congress intended to require a full 12-month period. *Witt,* DC Ga., 10/18/56.

Death benefits not exempt as foreign income. Amounts received by a nonresident widow under an employees' survivor benefit plan on account of services performed abroad by her deceased husband while a nonresident do not qualify as exempt income from foreign sources. The payments are not for her services (payment for which would be exempt); they are a death benefit. *Rev. Rul.* 56-524.

New procedural decisions this month

IRS can't proceed against transferee until it tries every way to collect from transferor. A father who owed taxes transferred his property to his daughter. The Government attempted to collect the taxes from the daughter. The court dismisses the action because the Government did not exhaust its remedies against the father. *Russell,* DC RI, 7/10/56.

Informal conference procedures outlined. The IRS has placed the informal conference function in the various district offices under the control of the Chief of Audit Division and has authorized him to delegate his duties to a conference coordinator under his immediate direction. Duties and responsibilities of the man in charge are outlined [See 5JTAX 345]. *Rev. Proc.* 56-34.

Insolvent taxpayer's wife liable for husband's taxes as transferee of his property. The Government brought suit to collect assessments made by the net-worth method. Taxpayer had purchased real property, with monies he had earned, and taken title in his wife's name, or in his and his wife's names. The court holds such properties subject to tax liens. *Payne,* DC Mo., 3/22/56.

Widow as transferee liable for husband's income tax. As executrix of her husband's estate, taxpayer distributed the assets to herself. As transferee of these assets, she is liable for an additional assessment of her husband's income tax. *Fecker,* DC Pa., 10/3/56.

The court has jurisdiction although petitioners filed as executors and claim overpayment as transferees. [*Acquiescence*] Decedent died a resident of Great Britain. His will created trusts in the United States of which petitioners were trustees. As the Code required, they filed a United States estate tax return as "executors" and paid the tax. The Commissioner later asserted a deficiency, but it then appeared that an overpayment had been made. The Tax Court ruled that it had jurisdiction to find an overpayment in favor of the petitioners as trustees and transferees, even though they paid the tax as executors. The latter designation was merely for convenience in establishing the requirement for filing returns on behalf of nonresident decedents. *Wilson Estate,* 26 TC No. 31 *acq.,* IRB 1956-46.

Taxpayer cannot refuse to pay taxes on the grounds that he would be a war criminal under international law. Taxpayer claimed that he had the right to refuse to pay two-thirds of his 1949 income taxes because this portion of the Federal Revenue had been appropriated by Congress for the preparation and the waging of aggressive war. The court grants the Government's motion for judgment on the pleading. It says that it does not have the authority to review the foreign policy or military program of the government, and that Congress has the right to levy taxes and to appropriate revenues for the common defense and general welfare of the country, and to provide for and maintain an army and navy. The courts have no power of review in these areas. *Farmer,* DC Tenn., 10/17/56.

Wife liable on joint return which she neither authorized nor signed. After taxpayer furnished her husband's accountant with information about her 1951 income, the accountant included it on a joint return without her knowledge or consent and signed her name to the return. Three months later she endorsed the refund check, and in a separate re-

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turn for 1952, she stated that she filed a joint return for 1951. The court concludes that taxpayer acquiesced in and gave her tacit consent to the filing of a joint return for 1951 and was therefore jointly and severally liable for that year's deficiencies. The trial judge dissents on the ground that she testified she did not authorize filing of the joint return; he questions the veracity of the accountant. Three other judges concur on the ground a conflict of testimony should be left to the trier of the facts. *Hein,* 27 TC No. 28.

Tax Court must follow circuit courts. The Sixth Circuit admonishes the Tax Court that it is bound by the decisions of the circuit courts and that it must follow the rule of the taxpayer's circuit. That the Tax Court has jurisdiction in tax cases throughout the U. S. does not make it superior to the district courts in any sense. *Stacy Mfg. Co.,* CA-6, 11/2/56. [Comment will appear shortly. *Ed.*]

Partnership loss determined for one partner; 3801 doesn't open other year. The Tax Court determined that taxpayer's partner had no partnership income for 1945 and 1946. These years were closed for taxpayer who had reported partnership income for those years. He argued that Section 3801 opened them. The court holds it does not. Assuming the partners are "related parties" and that the Tax Court decision is a "determination" the inconsistency is still not one the section covers. *Hagan,* CA-9, 11/13/56.

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Return signed only by wife upheld; Regulations invalid. Returns for 1943, 1945, and 1947 were signed only by taxpayer's wife. The Tax Court held that these were not returns and did not start the running of the statute of limitations. This court reverses. It notes the silence of the Code and the paucity of case law. The wife here had actual oral authority to sign her husband's name. Consequently, the return was valid. The Regulations prescribing conditions for filing by an agent (attached written power, etc.) are invalid because they are unauthorized by the Code. *Miller,* CA-5, 11/2/56.

Treasury agent can't use data from grand jury investigation in civil case. The grand jury turned over subpoenaed records to Treasury agents so that the agents could study the data and report back to the grand jury. The court limits the purpose of the investigation by the Treasury agents to advising the grand jury, and it prohibits the agents from using information so obtained from these records as evidence in any civil proceedings. At the time of the grand jury investigation, there were eight cases pending involving alleged tax liabilities of the various taxpayers involved. Misuse by the revenue agents of material obtained while aiding the grand jury would violate the Fourth and Fifth Amendments. The court considers questions relating to possible criminal trials to be premature. The validity of the grand jury's proceedings can only be reviewed after an indictment is handed down. *Cain,* CA-7, 11/13/56.

Overstatement of deduction not an omission extending statute of limitations. Taxpayer-farmer sold some breeding stock and reported the capital gain, but he took the same deduction twice; in his opening inventory, which he did not adjust, and in determining the capital gain. The Tax Court held that this constituted an omission from income for the purpose of extending the statute of limitations from three to five years. This court reverses; it agrees with the Third Circuit (*Uptegrove Lumber,* 204 F2d 570) that the statute applies only when a specific item of gain is omitted, not when costs or other deductions are overstated. *Goodenow,* CA-8, 11/8/56.

Can't enjoin collection of whisky tax after eight years in bond. The courts cannot enjoin collection of tax unless special circumstances warrant such drastic action. This taxpayer objects because the tax on whisky in bonded warehouses must be paid. After the whisky has been in the warehouse for eight years, even though it is still unsold, taxpayer is forced to sell it at a forced sale to raise money for the tax. The court holds that the remedy at law, suit for refund of taxes, is adequate in the absence of proof that taxpayer will be financially unable to pay the tax when it becomes due. *Schenley Distillers, Inc.,* DC Pa., 10/18/56.

Declaratory judgments not available in Federal tax matters. Taxpayer sought a declaratory judgment on whether or not it was tax-exempt. Taxpayer also sought an injunction against the Director for the same purpose, but this remedy is not available since it would be part of the relief incident to a declaratory judgment. The Declaratory Judgment Act expressly excepts controversies about Federal taxes from the jurisdiction of the district courts. *The Jolles Foundation, Inc.,* DC NY, 11/9/56.

Enjoin collection of partner's tax by sale of partnership property. Decedent owned an 85% interest in a partnership engaged in growing, harvesting, and selling vegetables. The Government proposed to sell partnership property in satisfaction of tax liens filed in connection with the assessment of additional tax against the decedent. The court finds that irreparable harm will be caused by a tax sale. The property is partnership property, and the partner's right in specific property is not subject to execution or attachment for a personal debt of the partner. Pending a decision on the merits, sale is enjoined. *Bushmiaer,* DC Ark., 11/19/59.

Exceptional circumstances required to restrain assessment. In an action brought by the taxpayer to restrain assessment of excise taxes against him, the Tax Court granted the Government's motion to dismiss the complaint on the ground that there were no circumstances which

could justify an exception to the general statutory rule prohibiting such suits. This court affirms. In the few cases where injunctive relief has been granted, the taxpayer showed not only that a proposed tax assessment was illegal but also that other special and extraordinary circumstances were present. *Martin*, CA-9, 11/15/56.

Resistered mailing of deficiency notice to last-known address sufficient to start 90-day period. On August 9 ,1955 the Commissioner mailed the statutory notice of deficiency by registered mail to taxpayer's last-known address. The postman did not find taxpayer at home and, in accordance with postal regulations, left a notice that a piece of registered mail was being held at the post office. Later the IRS phoned taxpayer and was asked to forward the letter to taxpayer's office. The letter, which bore the original mailing date of August 9 was received by the taxpayer on August 23, 1955. The Tax Court holds the 90-day period for the filing of a Tax Court petition began August 9, not August 23. Taxpayer was not misled about the date the Commissioner mailed the notice or the time which he had to file the petition. *Teel*, 27 TC No. 40.

Joint FPC rates don't force joint tax. IT 3930 and IT 3948 govern the determination of whether a joint operating agreement among co-owners of oil and gas properties creates an association taxable as a corporation. The IRS holds the Regulations of the Federal Power Commission relating to the filing of rate schedules and certificates under a joint operating agreement have no effect on this determination. *Rev. Rul.* 56-630.

Allowance of interest if overpayments reduce deficiencies. The Service changes its position on the computation of interest when overpayments of tax are credited to a deficiency. Previously, it had held in *Rev. Rul.* 55-485 that a demand for payment of a net amount, due by reason of offsetting overassessments against deficiencies, started interest running on the part of the tax satisfied by the credit. The Service now holds that additional interest will be collected and offset only if an unqualified notice and demand has been issued for the amount of the tax which was satisfied by credit of the overpayment. Taxpayers who have been charged interest on the amount satisfied by the credit on the basis of a qualified notice may file refund claims which will subject all open years to adjustment. *Rev. Rul.* 56-573, 56-574.

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Purported joint return not valid in absence of intent to file jointly. In April 1946 taxpayer and her husband permanently separated and in 1949 they divorced. The husband filed "joint returns" for 1946 and 1948, but she signed neither. The court holds she is not liable for deficiencies in those years, but is jointly and severally liable for 1947 deficiencies. She signed a blank return for the year and gave it to her husband. The court holds that she knew her husband intended to fill it and file it. *Douglas*, 27 TC No. 32.

Stockholder's loss on payment of liquidated corporation's tax is capital. As transferees taxpayers paid a corporate-tax liability which resulted from the disallowance of a portion of the salaries paid taxpayers as officers. Taxpayers contended that they were entitled to deduct the transferee liability as an ordinary rather than a capital loss because in effect they remitted part of their salaries when they paid the liquidated corporation's liability. Poiting out that taxpayers were under no legal obligation to repay the excessive salaries, the court holds the amounts paid as transferees, including preliquidation interest, were part of the capital loss on liquidation. *Ewing*, 27 TC No. 45.

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INDEX OF NEW DECISIONS REPORTED IN THIS ISSUE

NEW DECISIONS are listed below by the single significant word in the citation, generally the taxpayer's last or principal name. The number is page where summary will be found.

Acme Brick Co. 83
Alexander 93
Allgemeiner Arbeiter Verein 125
Atlanta Brick and Tile Co. 83
Baker 89
Baldwin Gardens 92
Berke 99
Bernstein Estate 99
Bessemer Limestone and Cement Co. 77
Bistline 89, 97
Boettcher 99
Bowden 124
Briggs 83
Brockel 97
Brodsky 91
Brown Estate 124
Bushmiaer 128
Cain 128
Carlson Estate 123
Carmichael 90
Chisholm Estate 124
Cobleigh 90, 93
Cohen 99
Danz 125
Day 97
Douglas 97, 129
Drilling and Service Inc. 78
Elgin-Butler Clay Brick Co. 83
English 97
Erickson 77
Ewing 129
Farmer 127
Finley 82, 97
Finney 88, 94
Flint and Fulton Inc. 88, 91, 94
Frank 97
Galant 99
General Motors 83
Given 92
Glenn 124
Goodenow 128
Graves 94
Gulf Atlantic Transp. Co. 92
Hagan 128
Hays Estate 98
Hein 128
Houston Oil Field 90
Hunt Engineering Co. 90
Independent Publishing Co. 93
Industrial Development Corp. 93
Insurance Club of Dallas 125
Ismert-Hincke Milling Co. 93
Jacobs Brothers 99
James Petroleum Corp. 94
Jockey Club 125
Johnson-McReynolds Chevrolet Corp. 78, 89
Jolles Foundation 128
Jordan 89
Karpe 97
Kenney Lumber Co. 77
Knipp Estate 124
Koppelman 94
Langford 98
Lasker 93
Lawrence 93
Lee 99
Marks 92
Martin 129
McDonough Estate 124
McKeon Estate 123
Mercer 98
Michael 91
Midwest Motor Express Co. 90, 91
Miller 98, 128
Minkoff 82, 92
Mohr 77, 97
Montana-Dakota Utilities 77
Montana Power Co. 78
Moorman 94
Murray 89
N. Y. Sun 92
Niederkrome 77, 82, 91
Ostler 97
Owensboro Wagon 83
Payne 127
Palda 82
Patent Button Co. 83
Peacock 78, 83
Pennroad 90
Perel & Lowenstein 78
Philbrick 90
Pierson 125
Post 98
Potter 125
Powell 98
Putnam 93
Reed 89
Rice 97, 98
Richmond Hosiery 83
Risko 83
Russell 127
Samkoff 98
Sanitary Farms 97
Schenley Distillers 128
Schwarz 98
Sharpe 94
Skarda 94
Sledge 89
Snellings 98
Solomon Estate 125
Southern Trading Co. 78, 89, 92
Spencer Quarries Inc. 92
St. Germain Foundation 128
Stacy Mfg. Co. 83, 128
Standard Oil Co. 94
Steele Estate 124
Stevens, Inc. 90
Stover Co. 92, 97
Studebaker-Packard Corp. 83
Swan Estate 124
Teel 129
Thompson 90
Tobey 91
Trainer 99
Traum 98
Tupelo Brick 83
2 Lex. Ave. Corp. 91
Union Paving Co. 89
Vita-Food Corp. 89
Waits Motors Inc. 78, 91
Wheeler 98
Whitaker Estate 90, 92
White 97
Williams 82
Wilshire-La Cienega Gardens Co. 78, 89
Wilson Estate 127
Witt 127

REVENUE RULINGS: The first number is that of the Ruling, the second is the page number where a summary of the ruling will be found.

56-475 125
56-487 127
56-523 83
56-524 127
56-542 83
56-559 78
56-571 103
56-572 77
56-573 129
56-574 129
56-582 92
56-583 97
56-584 78
56-585 97
56-587 91
56-594 127
56-596 103
56-598 97
56-599 94
56-600 93
56-601 125
56-602 90
56-610 94
56-611 93
56-612 97
56-623 78
56-630 129
56-633 103
56-635 127
Rev. Proc.
56-33 125
56-38 129
56-39 129
56-34 127

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257

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